



Hot Topics in Auditing

6 CPE Hours
CPAPDH10

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Hot Topics in Auditing

COURSE DESCRIPTION

The objective of this course is to review the latest developments affecting audit engagements.

Part of planning an audit involves consideration of the business and economic environment in which the client operates. Thus, auditors need to be aware of the various types of fraud that clients and employees may be committing, especially in light of myriad lawsuits against auditors and accountants. The course focuses on reviewing and recalling rules related to auditing standards including new developments pertaining to those standards.

Section 1:

After reading the Section 1 course material, you will be able to:

- Identify certain factors that an auditor may or may not consider in assessing going concern
- Identify audit procedures that an auditor should perform on receivables and inventories
- Identify the categories of securities found in existing GAAP
- Identify examples of fraud involving fraudulent financial reporting and misappropriation of assets
- Identify some of the audit procedures required to deal with the risk of management override of internal controls
- Recognize an acceptable type of indemnification clause that an auditor can use

Section 2:

After reading the Section 2 course material, you will be able to:

- Identify a fact related to the concentration of auditors in the larger public company market
- Recognize a recommendation made to address auditor liability

| | |
|--------------------------|--|
| Field of study: | Auditing |
| Level of knowledge: | Overview |
| Prerequisite: | General understanding of auditing standards |
| Advanced preparation: | None |
| Recommended CPE hours: | 6 |
| Course qualification: | Qualifies for both NASB QAS and Registry CPE credit based on a 50-minute per CPE hour measurement. |
| CPE sponsor information: | NASBA Registry Sponsor Number: 138298 |

Table of Contents

SECTION 1: Auditing Developments

General Developments

I. Introduction:

II. Implications of the Current Economic Environment- Economic Issues Peculiar to Auditors

1. Status of the U.S. economy in 2016 and its impact on auditors:

2. Specific Accounting risks

REVIEW QUESTIONS

SUGGESTED SOLUTIONS

III. Client and Employee Fraud

1. General

2. 2016 Report to the Nations on Occupational Fraud and Abuse

REVIEW QUESTIONS

SUGGESTED SOLUTIONS

3. Types of Fraud

4. Small Business Fraud

5. Evaluating an Entity's Fraud Environment

REVIEW QUESTIONS

SUGGESTED SOLUTIONS

6. Time Theft

7. Employee Background Checks and Credit Reports

8. The Auditor's Role in Dealing with Fraud

9. Specific Fraud Issues

10. Anti-Fraud Measures

11. Sentences for Fraudsters

12. A Fraud Scorecard

13. Computer Crime and Theft

14. Integrity Survey

15. Correlation Between Bankruptcy and Fraud

16. The CFO Perspective on their Outside Auditors and Fraud

17. Madoff and the Single Auditor Issue

REVIEW QUESTIONS

SUGGESTED SOLUTIONS

SECTION 2: Auditing Developments

IV. Attempting to Limit Auditor's Liability

V. The Viability of the Big Four

VI. The Effect of Enron- 14 Years Later

VII. Going Concern Issues

REVIEW QUESTIONS

SUGGESTED SOLUTIONS

Auditing Developments

General Developments

I. Introduction

Throughout the audit process, auditors should consider overall engagement risk.

The three components of engagement risk are as follows:

- **Client business risk:** The risk associated with the entity's survival and profitability.
- **Auditor's audit risk:** The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.
- **Auditor's business risk:** The risk of potential litigation costs from an alleged audit failure and the risk of other costs such as fee realization and reputational effects from association with the client.

II. Implications of the Current Economic Environment- Economic Issues Peculiar to Auditors

In planning an audit, the auditor is required to comply with SAS No. 122, AU-C Section 300, *Planning an Audit*.¹ AU-C Section 300 requires that the auditor establish an overall audit strategy and develop an audit plan.

As part of its planning, an auditor must follow SAS No. 122, AU-C Section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.² AU-C Section 315 requires an auditor to perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal control.

Each industry is subject to specific business risks arising from the nature of the business. Business risks arise from certain conditions, events and circumstances.

Factors that an auditor may consider in understanding the entity and its environment include:

1. Industry, regulatory, and other external factors, such as:
 - The market and competition
 - Cyclical or seasonal activity
 - Product technology

¹ Effective December 31, 2012, SAS No. 108 is replaced by AU-C 300, *Planning an Audit*.

² Effective December 31, 2012, SAS No. 109 is replaced by AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

- Supply availability and cost
- Accounting principles and industry-specific practices
- Legislation and regulation affecting the entity's operations
- General economic level
- Interest rates, financial, inflation and currency revaluation issues
- Relevant accounting pronouncements
- The legal and political environment
- General economic conditions
- Competitive and technical conditions
- Social conditions

2. Nature of the entity including:

- Ownership
- Entity's operations
- Governance
- Financing sources and structure
- Related party transactions

3. Objectives and strategies and related business risks

4. Measurement and review of the entity's financial performance

5. Internal control, including the selection and application of accounting principles

Any of the above factors can affect several aspects of the audit including going concern, fraud, internal control, use of accounting estimates, and analytical procedures, to name a few.

Although most risks eventually affect the financial statements, not all such risks result in material misstatements to the financial statements. Consequently, the auditor is not responsible for identifying or assessing all business risks.

The seeds are sown during the good times!

The seeds of accounting and business problems that sprout during an economic downturn are often planted during stronger economic times. Then, they are reversed during a downturn. Given the flat economic climate, it is likely that clients set the groundwork for accounting issues years ago during the last boom.

More specifically, during stronger times:

- There is continued pressure on management to generate stronger financial results commensurate with the stronger economy and stock market.
- Management may enter into riskier business ventures during stronger economic times to fuel continued expectations to improve performance.
- Auditors may “let their guard down” during times of economic growth as there is evidence that a company is doing well and the purported risk of business failure is relatively low.
- Businesses are more likely to set up “rainy day” funds such as inflating liabilities, allowances and reserves beyond the amounts that are needed, with the plan to reverse the excess amounts during a downturn.

In the following section, the author discusses several key business and economic conditions that exist and are expected to exist through 2017.

1. Status of the U.S. economy in 2017 and its impact on auditors:

In general, the U.S. economy is still flat, with some signs of recovery in the aftermath of a new presidential administration. In early 2017, there has been a spike in consumer and business confidence in anticipation of tax and regulatory reform in 2017. Although there is low inflation and interest rates, unemployment is still relatively high with published unemployment hovering around 4% to 5% and the “real” unemployment rate in the 12% to 14% range. Interest rates are expected to increase in 2017 and 2018 as the Federal Reserve has already increased the Federal Funds Rate by .25% and has announced as many as three additional .25% increases in 2017.

Economic trends that auditors should be aware of include the following:

- The real estate market, particularly in the residential housing sector, has expanded aggressively in certain areas fueled by low interest rates.
- Real GDP limped along in 2016 at a pace of about 1.2% per annum which is well below a healthy level of 2.5% to 3%, or greater.
- The Federal Reserve has announced and implemented a plan to increase short-term interest rates over the next few years. The 2016 increase in rates by .25% is likely to be followed by a total .75% increase in rates in 2017.
- Americans are still carrying record levels of personal debt.
- The reported unemployment rate continues at around 4 to 5 percent with the real rate much higher when computed using full-time (rather than part-time) employment and labor participation rates. Overall jobs reports have shown a weakness in new hires.
- Although interest rates are still low, credit is difficult to obtain as underwriting is extensive due, in part, to new regulations promulgated by the Dodd-Frank Act.

- The stock market has rebounded to more than 20,000 in the Dow Jones.

Despite the fact that certain segments have rebounded, the inconsistency and volatility of the overall economy has driven concern as investors are unwilling to make significant investments in capital formation particularly with an uncertain tax and regulatory policy at the federal level. Although it may be too early to tell, there appears to be signs of increased business confidence as the Trump Administration has announced immediately plans for a reduction in corporate tax rates, regulatory reform, and a repeal of the Affordable Care Act (ACA). These proposed changes have resulted in higher business optimism that the cost of doing business in the United States is likely to decline.

2. Specific accounting risks

In this section, the author identifies certain accounting risks that are a byproduct of the existing economy, some of which are noted in the previously issued AICPA's *Audit Risk Alerts*, as modified by the author.

Risks of inadequate liquidity:

Some entities are more sensitive than others to negative changes in economic conditions, which can lead to the risk of a going concern issue. In particular, companies that have significant concentrations in major customers and suppliers are at the greatest risk. Although a company may have experienced strong growth over the past few years, its major customers and suppliers may not. The loss of a major customer or supplier could disrupt an otherwise financially healthy client and, in some cases, result in its demise.

SAS No. 122, AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*,³ provides guidance on evaluating the adequacy of going concern disclosure in audited financial statements.

As a general rule, auditors should always be cognizant about going concern. Factors they should consider in every audit include:

- Negative trends and recurring operating losses or working capital deficiencies
- Financial difficulties such as loan defaults or denial of trade credit from suppliers
- Concentrations such as reliance on one product line
- Legal proceedings or loss of a principal supplier
- Ability to obtain external financing, and
- Reliance on external financing, rather than internally generated income, as a source of cash.

³ Effective December 31, 2012, AU-C Section 570 replaces SAS No. 59.

Auditors may have to consider whether there is substantial doubt of an entity's ability to continue as a going-concern for a reasonable period of time, and whether the auditor must seek factors that mitigate this fact.

Ratios to consider in evaluating liquidity

In assessing going concern, an auditor may wish to perform certain cash flow analyses to assess an entity's liquidity. Typically, assessing cash flow is more important than evaluating an entity's financial position or statement of income.

In particular, two cash flow ratios are effective in assessing liquidity:

Funds Flow Coverage (FFC) Ratio

$$\frac{\text{EBITDA}^4}{\text{Interest paid} + \text{tax-adjusted debt repayments} + \text{tax-adjusted preferred dividends}} = \text{Funds Flow Coverage (FFC) Ratio}$$

Cash Interest Coverage Ratio

$$\frac{\text{Cash from operations} + \text{interest paid}}{\text{Interest paid}} = \text{Cash Interest Coverage Ratio}$$

The cash interest coverage ratio should always be at least 1.0 resulting in the company having enough cash to fund its interest.

Risks of collectability of accounts receivable:

Currently, both consumers and businesses are carrying high levels of debt as the cost of debt has been relatively cheap. As interest rates rise, the quality of trade and consumer receivables could quickly deteriorate as customers no longer qualify for the same amount of financing as they did during a lower interest rate environment. Consequently, customers may use their trade payables as an inexpensive line of credit by stretching payment periods and taking fewer cash discounts. Even customers who show signs of stable earnings may still have severe cash flow problems as the cost of their debt service rises that may result in the inability to fund payment of obligations due to their vendors. Auditors should be more diligent in evaluating accounts receivable due

⁴ Earnings before interest, taxes, depreciation and amortization = EBITDA

from both domestic and foreign customers, including the collectability of amounts due and the adequacy of the allowance for doubtful accounts and possible loan impairment.

Audit procedures with respect to receivables and, in particular, the adequacy of the allowance for doubtful accounts, include the following:

1. Test the aging, including the reliability of the aging report, review past due accounts, the client's history of collecting past due balances, and customer files and credit reports.
2. Obtain publicly available information on major customers to determine their ability to honor outstanding obligations of the company.
3. Investigate unusual credit limits or nonstandard payment terms given to customers.
4. Test the realization of receivables (e.g., subsequent collections).
5. Test to ensure that the cash payments credited to an accounts receivable account actually came from that customer.
6. Perform analytical procedures such as:
 - Receivables turnover
 - Bad debts as a percentage of net credit sales
 - Allowance balance to accounts receivable
 - Number of days sales in receivables
7. Review revenue and receivables transactions and fluctuations after the balance sheet date for sales returns and unusual items.
8. Review the collectability of vendor financing given to customers.
9. Evaluate the reasonableness of the allowance for doubtful accounts by following the guidance in SAS No. 122, AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*.⁵
 - Review and test the process used by management to develop the estimate

⁵ Effective December 31, 2012, AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, replaced SAS No. 57.

- Develop an independent expectation of the estimate to corroborate the reasonableness of the estimate
- Review subsequent events or transactions occurring before the completion of field work, including returns, chargebacks, and payments by customers, and
- Perform a *retrospective review* (as required by AU-C 240) of the allowance balance last year by comparing that allowance balance estimate to the actual bad debt writeoffs after year-end.

Note: SAS No. 122, AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit*,⁶ requires an auditor to perform a retrospective review of significant estimates to determine whether there was management bias in establishing those estimates. In performing the retrospective review, the auditor compares the prior year's estimate to the actual outcome related to that estimate. For example, in performing a retrospective review of an allowance for doubtful accounts, the auditor would compare the prior year's allowance balance (the estimate) to the actual bad debt writeoffs recorded after year end. In doing so, the auditor can determine the degree of accuracy used in establishing the prior year's estimate and whether there was management bias in establishing that prior year's estimate. Information about the results of the prior year will assist the auditor in assessing the current year's estimate.

Risks of inventory writedowns and obsolescence:

In recent years as a whole, companies have efficiently lowered their inventory levels as demand for their products decreased. Some still have excess inventories that have been held for a long period of time leading to the question of whether such inventories are salable or obsolete, requiring a writedown to lower of cost or market value. In addition, if the economy does slow down, even typically high turnover items may become slow moving.

In auditing companies with significant inventories, auditors should consider the following:

1. An unusual increase in inventory balances, reduced turnover, increased backlog and a deterioration in the aging of inventories may be signs that there is excess inventory on hand.
2. Reduced prices and profit margins may cause inventories to be valued over market value.
3. Idle capacity at a manufacturing facility may result in an overcapitalization of overhead and a valuation in excess of market value.
4. Certain factors may lead to obsolescence of existing inventory such as:
 - Changes in the product design.

⁶ Effective December 31, 2012, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, replaced SAS No. 99.

- A competitor may introduce a newer, more advanced version of a product.
- New products promoted by the industry may have features that are superior to those of the company's existing products.
- Lower-priced imports may affect the value of existing inventories.

Specific auditing procedures should be performed to determine if inventories are properly valued and to identify slow moving, excess or obsolete inventories. Suggestions of effective audit procedures are noted below.

1. Specific auditing procedures to determine if inventories are properly valued include reviewing:

- Product sales trends and expected future demand
- Sales forecasts for products in comparison to industry demand
- Anticipated technological changes that could affect the value of inventories
- New product lines planned by management and the effect of those lines on existing inventories
- New product announcements by competitors
- Economic conditions in markets in which the products are sold
- The impact of changes in the regulatory environment on demand for the products
- Changes in raw materials prime costs that might affect the pricing of the finished goods inventories
- Pricing trends of products
- Changes in the standards used by the industry to value inventories

2. Specific auditing procedures that can be performed to identify slow-moving, excess, or obsolete inventories include:

- Examine and test the inventory turnover, by product, by comparing sales volume with inventory balances

- Review industry trends
- Tour the facility to inspect inventories that appear to be obsolete or damaged
- Ask personnel about items that may be obsolete
- Review sales cancellations and returns after year end

If significant obsolete inventories exist, it may be appropriate to include the matter in the management representation letter.

Note: ASC 330, *Inventory* (formerly FASB No. 151), amended guidance for inventory cost capitalization found in ARB No. 43, Chapter 4, *Inventory Pricing*. ASC 330 made two changes to ARB No. 43. First, it requires that *abnormal amounts* of idle facility expense, freight, handling costs, and wasted materials (spoilage) be recognized as current period charges and not capitalized as part of production overhead. Normal amounts of idle facility expense, freight, handling costs, and wasted materials (spoilage) continue to be capitalized as part of overhead.

The second change is that fixed production overhead should be allocated to inventories based on normal capacity of the production facilities. Normal capacity is the production expected to be achieved over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. Variable production overheads continue to be allocated to each unit of production based on actual use of the production facilities (e.g., actual production volume).

A key change made by ASC 330 is that it requires companies to capitalize fixed overhead using the greater of normal capacity or actual production in the denominator. In making this change, the FASB eliminated the risk during an economic downturn, that a company could overcapitalize fixed overhead by allocating overhead using a lower actual production level.

Get ready for 2017 inventory valuation changes under ASU 2015-11

Auditors should get ready for changes coming to the way in which certain inventories are valued.

ASU 2015-11: Inventory (Topic 330) Simplifying the Measurement of Inventory, amends ASC 3330, *Inventory*, to remove use of lower of cost or market for FIFO and average cost inventories.

A summary of the key provisions of the ASU follows:

1. ASU 2015-11 applies to all inventory valuation methods *other than* LIFO and retail inventory methods.

2. The ASU makes no changes to inventory measured using LIFO or the retail inventory method.
 - a. LIFO and retail inventory methods continue to use lower of cost or market.
3. Under the ASU amendments, an entity is required to measure FIFO or average cost inventories at lower of cost and net realizable value.
 - a. For FIFO and average cost inventory, lower of cost or market is no longer used. Use of replacement cost, with a ceiling and floor, is eliminated, and replaced with one outcome which is net realizable value.
5. Net realizable value (NRV) is defined as estimated selling prices less costs of completion, disposal and transportation.

Other than the change in the measurement guidance from the lower of cost or market to the lower of cost and net realizable value for inventory within the scope of the ASU, there are no other substantive changes made by ASU 2015-11 to the measurement of inventory.

The ASU changes are effective for calendar year 2017 audits for both non-public and public companies and is applied prospectively to 2017 year-end inventories.

Even though the effective date is the end of 2017 engagements, auditors should review the changes with their audit clients to ensure that procedures are in effect to make the ASU 2015-11 changes at the end of 2017.

Risk of impairment of assets:

ASC 360, *Property, Plant and Equipment* (formerly included FASB No. 144), and ASC 350, *Intangibles-Goodwill and Other* (formerly FASB No. 142), encompass the impairment rules for long-lived assets. Specifically, ASC 360 applies to fixed assets, real estate, and intangible assets with finite lives, and requires a company to test such assets for impairment if factors indicate an impairment may exist. On the other hand, ASC 350 applies to the impairment of goodwill and intangible assets with indefinite lives, and requires that an annual test for impairment be performed regardless of the conditions that exist.

Regardless of the trend in the economic cycle, there is the risk that long-lived assets can be impaired. For example, regardless of whether demand expands or contracts, there is still the concern that long-lived assets such as equipment may become impaired due to technological obsolescence.

In addition to equipment, an auditor should focus on the risk that real estate values have declined due to numerous factors including an overall building glut (supply exceeds demand) and a slight uptick in interest rates. The result is that companies may have real estate that is impaired and needs to be tested for impairment.

Specifically, ASC 360 states that an impairment loss exists when the carrying amount of real estate or other long-lived assets exceeds its fair value.

Real estate is tested whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. Examples of events and changes in circumstances that might warrant a test include:

- Significant decline in the market price of the real estate or similar real estate
- Continued decline in rental rates and increased vacancies
- Failure to meet debt service on a regular basis
- Change in the use of the property
- Known environmental contamination
- Legal changes such as rent control or use restrictions

Auditors should consider whether ASC 360 applies if any of the above factors are present.

In September 2011, the FASB issued ASU 2011-08, *Intangibles—Goodwill and Other (Topic 350, Testing Goodwill for Impairment)*.

ASU 2011-08 amends ASC 350 to do the following:

- a. It provide that in testing goodwill for impairment, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not (more than 50% probability) that the fair value of a reporting unit (entity) is less than its carrying amount.
- b. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not (not more than 50% probability) that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit (entity) and comparing the fair value with the carrying amount of the reporting unit.

In July 2012, the FASB issued Accounting Standards Update (ASU) 2012-02 entitled, *Intangibles—Goodwill and Other (Topic 350) Testing Indefinite-Lived Intangible Assets for Impairment*.

The overall objective of the ASU is to permit (but not require) that an optional qualitative assessment of impairment be permitted for intangible assets with indefinite lives, similar to the qualitative assessment permitted for goodwill by ASU 2011-08.

The optional qualitative assessments offered by ASU 2011-08 for goodwill and ASU 2012-02 for intangible assets with indefinite lives, make it much easier to test for impairment. In particular, both qualitative assessments take away to requirement to measure fair value as part of the initial test for impairment.

Private company election to amortize goodwill

In January 2014, the Private Company Council (PCC) issued ASU 2014-02: *An Amendment of the FASB Accounting Standards Codification® Intangibles—Goodwill and Other (Topic 350) Accounting for Goodwill- a consensus of the Private Company Council*. ASU 2014-02 permits a private company to elect to amortize goodwill on a straight-line basis over a maximum of 10 years. If a private company does make the election to amortize goodwill, the annual test for goodwill impairment is not required. Instead, an impairment test is only required if there is a triggering event that occurs that indicates that the fair value of the goodwill may be less than its carrying value.

ASU 2014-02, if elected, is effective for annual periods *beginning after December 15, 2014*, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted.

Risk of investment writedowns:

ASC 320, *Debt and Equity Securities* (formerly FASB No. 115) deals with the accounting for securities. ASC 320 places securities into three categories as follows:

1. Debt securities held-to-maturity: Debt securities that management plans to hold until maturity.
2. Trading securities: Both debt and equity securities that are bought and held for the purpose of selling them in the near term (generally within one year).
3. Available-for-sale securities: Both debt and equity securities that are not categorized as either held-to-maturity or trading securities, are automatically categorized as available-for-sale. In this category, management has essentially not decided what it plans to do with the securities.

The following table summarizes the accounting treatment for investments.

| | -----Securities----- | | | Non-securities |
|--|----------------------------------|----------------------------------|---|---|
| | Debt securities held to maturity | Trading securities | Available for sale securities | All non-security investments |
| Type | Debt | Debt and equity | Debt and equity | Debt and equity |
| Intent | Hold to maturity | Sell in the near term | Undecided | Not applicable |
| Record at | Cost | Fair value | Fair value | Cost |
| Unrealized gains or losses | Not applicable | Presented on income statement | Presented in stockholders' equity, net of tax | Not applicable |
| Balance sheet classification (current vs. long-term) | Based on maturity date | Current even if sale is expected | Based on management's intent at year end | Current or non-current based on management's intent |

| | | | | |
|-----------------------------------|--|--------------------|--|--|
| | | beyond one year | | |
| Other than temporary losses | Investment written down and unrealized loss is recognized | | | |

An auditor should be aware of several important accounting issues related to the accounting for investments:

1. Unrealized losses on equity securities: There is the risk that equity security values may decline in value, resulting in unrealized losses having to be recorded in accordance with ASC 320 (formerly FASB No. 115). Management may attempt to classify such investments as available for sale, so that unrealized losses will be presented as part of stockholders' equity. ASC 320 has strict rules precluding management from shifting among investment categories except in rare instances.
2. Accounting for held-to-maturity investments: In accordance with ASC 320, an entity must classify securities into one of three categories: a) held-to-maturity, b) trading, and c) available for sale. Held-to-maturity securities are recorded at amortized cost, and include those debt securities that management has the positive intent and ability to hold to maturity.
 - a. When debt securities decline in value, management may take steps to avoid having to record the unrealized losses on the income statement. One way is to classify debt securities as held to maturity so that the investment is recorded at carrying value and the loss is not recorded. Such an investment may have previously been recorded as available for sale thereby requiring management to change the classification of the investment.

ASC 320 provides a list of changes in circumstances that shall not be considered to be inconsistent with the original intent of holding the security to maturity. That is, an entity may change the classification to held-to-maturity.

3. Other than temporary losses: Companies may be holding equity or debt investments (publicly or non-publicly held), that have significant unrealized losses. Some of the losses have recovered, while others have not. The accounting for these investments depends on numerous factors including whether the investments are securities (publicly held), and the intent of management.
 - a. Existing GAAP generally assumes that investments will fluctuate over time and, therefore, unrealized gains and losses may reverse. However, there are instances in which an investment has an unrealized loss that management believes will not reverse. That is, the loss is *other-than-temporary* and is not likely to recover over time. In such instances, GAAP provides an overall rule requiring the unrealized loss to become realized and recognized on the income statement.

Risk of manipulation of estimates and accruals:

It is common for management to use estimates as a means to manage earnings. So called “rainy-day” or “cookie-jar” funds are used to set aside extra reserves to be reversed to income when needed in future periods.

Auditors should be aware of the risks associated with management’s use of overly aggressive estimates; that is, those estimates that may either under- or over-state earnings. Because estimates are subjective and may be correct within a range, auditors should be able to ascertain as to whether management’s estimates are reasonable within an acceptable range. Of particular concern should be changes in estimates that are not supported by reasonable assumptions.

In auditing estimates, an auditor should do the following:

1. Follow the guidance of SAS No. 122, AU-C Section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, which provides that in auditing estimates, the auditor should:
 - Identify the circumstances that require the estimate
 - Consider internal control related to developing the estimate
 - Evaluate the reasonableness of the estimate by reviewing and testing the process used and the assumptions made, and
 - Perform an independent expectation of the estimate.
2. There should be a preponderance of information to support each significant assumption. The weight of available evidence supports the assumption. In evaluating the assumptions, an auditor’s consideration should be given as to whether:
 - The sufficiency of the sources of information about the assumptions has been considered
 - The assumptions are consistent with the sources from which they were obtained
 - The assumptions are consistent with each other and with management’s plans
 - The information used to develop the assumptions is reliable, and
 - The logical arguments or theory considered as a whole, are reasonable.
3. Changes in estimates may be acceptable if such a change is supported by real economic facts. Changes that are not supported by the underlying economics of the business are inappropriate.
4. Unrealistic pension and other postretirement and postemployment plan assumptions:
 - Assumptions used to measure pension, postretirement and post-employment liabilities must be evaluated including discount rates, participation rates, and other factors that affect the liabilities.

5. An auditor should consider the effects of post-balance-sheet events on the estimation process. Such events may require adjustment or disclosure in the financial statements.
6. An auditor should comply with the requirements of AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99), by performing a review of significant estimates for management bias:
 - a. The auditor should consider whether there are differences between the best supported estimates and the estimates included by management in the financial statements that suggest a possible bias.
 - b. The auditor also should perform a *retrospective review of significant accounting estimates* reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.

Certain estimates likely will be subject to performance of a retrospective review, including:

- Allowance for uncollectible accounts
- Reserve for obsolete inventory
- Accruals for post-employment and post-retirement benefit obligations
- Contingency liabilities and those related to environmental remediation obligations

FASB issues ASU 2016-01: Financial Instruments—Overall

In January 2016, the FASB made dramatic changes to the accounting for financial instruments with the issuance of ASU 2016-01, *Financial Instruments- Overall*.

ASU 2016-01 is effective in 2018 for public companies and 2019 for non-public companies.

ASU 2016-01 makes the following amendments to the accounting for financial instruments:

1. Requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income.
2. Eliminates the categorization of an equity investment as available-for-sale with the change presented as part of other comprehensive income in stockholders' equity.
3. Simplifies the impairment assessment of equity investments without readily determinable fair values.
4. Eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities.
5. Eliminates and modifies various disclosures related to both public and nonpublic entities.

6. Clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale debt securities in combination with the entity's other deferred tax assets.
7. Retains the existing three-categories (held to maturity, trading and available for sale) for debt securities.

Although the changes made by ASU 2016-01 are not effective until 2018 or 2019, auditors should educate their clients as to the forthcoming changes and plan to implement them on the effective date.

Risk of improper revenue recognition:

In 2014, the FASB made transformative changes to the accounting for revenue with the issuance of ASU-2014-09, *Revenue from Contracts with Customers*. The changes made by ASU 2014-09 are not effective until 2018 (2019 for nonpublic entities). Until ASU 2014-09 is implemented, auditors must audit revenue based on existing GAAP.

Background

Revenue recognition continues to head the list of areas subject to fraudulent financial reporting. In particular, many frauds have focused on the premature recognition of revenue, such as in the case of several software vendors who have prematurely recognized revenue to satisfy revenue targets. Common approaches used to prematurely recognize revenue range from recognizing revenue before it is earned, to actually falsifying sales that do not exist.

According to various sources, revenue recognition issues account for approximately 50 percent of all financial statement frauds. Some of the more important revenue issues include the following:

1. Recognition of revenue prematurely such as:
 - “Channel stuffing” (shipping inventory in excess of orders, or giving customers incentives to purchase more goods than they need in exchange for future discounts or other benefits)
 - Reporting revenue after goods are ordered but before they are shipped
 - Reporting revenue when significant services have not been performed
 - Improper use of the percentage-of-completion method, and
 - Improper year-end cutoff procedures.
2. Recognition of revenue that has not been earned including:
 - Recognizing revenue on bill and hold transactions, consignment sales, sales subject to contingencies, and those with the right to return goods, sales coupled with purchase discounts or credits, and other side agreements.
3. Reporting sales to fictitious or nonexistent customers

4. Sales to related parties in excess of market value
5. Recognizing transactions at fair value that relate to exchanges of non-monetary assets that should be accounted for at carrying value
6. Reporting peripheral or incidental transactions, such as nonrecurring gains⁷

In addition to traditional revenue manipulation strategies, there are numerous methods that a company can use to recognize revenue, subject to certain limitations, including:

- Traditional sales method
- Percentage completion method
- Completed contract method
- Installment sales method

Thus, it is clear that there are simply too many variations in both methods and applications related to such a key financial statement item such as revenue.

Multiple-element arrangements

Many sales transactions have multiple elements or deliverables, each with its own delivery date and performance requirements. For example, the sale of an appliance may include three deliverables bundled under one contract: the sale of the appliance itself, installation, and a warranty contract. Because most multiple element sales arrangements are bundled together under one contract with one aggregated price for all deliverables, there are challenges as to how to allocate the sales price among the deliverables and when to recognize each portion of revenue related to a particular deliverable.

ASC 605-25, *Revenue Recognition-Multiple Element Arrangements* (formerly EITF 08-1), provides guidance on how to account for such multiple deliverable arrangements.

Because multiple deliverable arrangements are complex and subject to manipulation, auditors must be familiar with the GAAP requirements. In particular, auditors must be able to test such arrangements to make sure:

- Revenue is not misallocated to those deliverables that are performed first, thereby resulting in the premature recognition of revenue, and
- Revenue allocated to a particular deliverable is not recognized prior to performance of all activities required to earn that revenue.

⁷ *Financial Statement Fraud, Integrity of Financial Information Continue to Be Burner Issues* (AICPA)

Risk of having underfunded pension plans:

Many companies with defined benefit pension plans are experiencing a major challenge in that they have significant underfunded pension plans. These plans have actuarial liabilities that exceed the fair value of the assets in the plans. Under the ERISA rules, these companies must continue to fund these plans, thereby requiring sizeable amounts of cash paid now to fund future retirees. More specifically, the Pension Benefit Guaranty Corporation (PBGC) is facing growing deficits due to the continued failings of pension plans.

Reasons for the current pension plan deficiencies include:

- Stock market values have declined over the past decade even though there was a partial recovery in 2012 through the end of 2016.
- Pension benefit obligations have risen due to the average age of retirees increasing as retirees live longer.
- Interest rates have declined resulting in companies having to calculate higher pension liabilities as pension liabilities are discounted at lower interest rates commensurate with AA or AAA-rated bonds.
- Higher pension obligations and lower fair value of assets together have created the current pension deficiencies in funded status.

Observation: In December 2016, the S&P 1500 had a pension deficit of \$(414) billion in 2016, a slight deterioration from \$(404) billion in December 2015. The total fair value of assets was essentially flat at \$1.796 trillion and \$1.800 trillion in 2016 and 2015, respectively. The pension obligations increased slightly from \$2.204 trillion in 2015 to \$2.210 trillion in 2016. The liability increased for two reasons. First, there was a change in the longevity assumptions as plan participants are expected to live longer. Second, the discount rate declined slightly as the AA and AAA bond rates declined.

What happened in 2016 represents the continued battle that all defined benefit plans have. As retirees live longer, plans have pressure to drive the increase in asset values to pay for those additional benefit liabilities. Only higher interest rates can help reduce those liabilities to offset the increase in the longer retirement periods.

Companies with unfunded pension liabilities face certain repercussions from such deficiencies in that:

- Companies can have a cash flow crunch from having to fund the unfunded liabilities to satisfy legal ERISA requirements.
- Under ASC 715, *Defined Benefit Plans* (formerly FASB No. 158), an entity that sponsors one or more defined benefit plans is required to record the funded status of a benefit plan, measured as the difference between the fair value of plan assets and the benefit obligation, in its balance sheet.
- If the fair value of the plan assets is less than the benefit obligation, the company must record an additional liability with the debit offset to accumulated other comprehensive income (part of stockholders' equity). The combination debit to stockholders' equity and credit to a liability account may result in violations of loan covenants, including debt-equity ratios being out of formula.

Management must continue to monitor and change the key assumptions used to measure pension benefit obligations, returns on assets, and periodic pension cost, to reflect changes in the economy. The primary actuarial assumptions used include:

- Discount rates
- Expected rates of returns on assets
- Participation rates
- Factors affecting the amount and timing of future benefit payments

In addition, if activity within the existing plan has a material effect on the company's liquidity, capital resources, or results of operations, the activity must be discussed in the MD&A for SEC companies.

The impact of the PPA of 2006:

Congress passed the Pension Protection Act of 2006 (PPA or Act) which expanded and improved defined benefit plans such as 401(k) plans, and strengthens the federal pension insurance program.

Although the PPA has been in effect for more than a decade, management and its auditors should understand its general provisions that include:

- An increase in premiums for underfunded plans and for termination of plans
- A requirement for accurate measurement and reporting of benefit obligation liabilities
- A prohibition against employers promising additional benefits to employees until they are actually funded, and
- A prohibition against deferral of contributions to under-funded plans.

Impact of new mortality tables on defined benefit plans:

In October 2014, the Society of Actuaries (SOA) released new mortality tables found in RP-2014 and a new mortality improvement scale referred to as MP-2014. These new tables directly impact company defined benefit plan liabilities.

Per SOA, the new mortality tables are based on about 10.5 million life-years of exposure and more than 220,000 deaths, submitted from a total of 123 private and public/federal pension plans. The mortality assumptions previously used were developed from data that was more than 20 years old based on mortality experience from years 1987 to 1992.

The new mortality tables reflect expanded life expectancies which will be reflected in actuarial computations of plan obligations.⁸

The results of the new tables follow:

1. Life expectancies of 65-year old individuals in the United States have increased from:
 - 84.6 years to 86.6 years for men, and
 - 86.4 years to 88.8 years for woman.
2. The effects of the new tables on companies with significant defined benefit pension and OPEB obligations is that longer life expectancies yield significantly higher plan obligations.
 - An average of two years of future benefit payments must be added to the plan obligation liability on sponsor financial statements.

Note: The immediate income statement effect has been minimal. GAAP permits the adoption of the new tables to be recognized in other comprehensive income (OCI) and be amortized into net income over several years.

- Plan sponsors must use the revised mortality tables in developing assumptions affecting benefit obligations and contributions.

Note: ASC 715-30-35-42 and 715-60-35-72 require that the best available information be considered as of the measurement date including using the best estimate when using assumptions, including life expectancy.

- If the new tables are used to calculate the plan sponsor's benefit costs and obligations, they should also be used for the plan's financial statements.
- The IRS did not reflect the new tables in its minimum funding standards for 2014 and 2015 but did use them in its tables for setting minimum funding standards for plans beginning in 2016.

3. The new mortality assumptions and longer life expectancies affect the following:

⁸ Society of Actuaries (SOA)

- Higher contribution requirements
 - Benefit restrictions
 - Lower balance sheet funded status (assets minus liability will be lower)
 - Higher lump-sum payouts, and
 - Higher PBGC variable rate premiums
4. By using the new mortality tables, companies are adding an average of 2 years of pension payments in the computation of their pension obligations.⁹

Auditor concerns about pension plans:

Auditors of companies with defined benefit plans must consider the following auditing procedures in connection with the plan:

- When auditing estimates, the auditor should give close attention to the underlying assumptions used by management and the risk that aggressive assumptions may understate the pension liability. Those assumptions should reflect the updated actuarial tables issued by the SOA.
- When there are significant underfunded pension plans, including multi-employer plans, the auditor should consider whether the company has a going concern problem from its joint and several liability for the underfunded plan status.

Risk of understated expenses:

Management may be motivated to understate expenses to hide losses or sub-par profits.

Methods that can be used to understate expenses include:

- Capitalizing expenses that provide no future benefit, and
- Understating accounts payable at year end.

History has shown that management can beat the auditors by understating or hiding expenses a little at a time over several periods.

Audit procedures that should be employed to test for under-recorded expenses include:

- Search for unrecorded liabilities through examination of post-balance sheet transactions

⁹ Tower Watson estimated that the funded status of the 400 largest U.S. company pension plans declined by \$72 billion in 2014 due to use of the new mortality table assumptions. Information on the impact on 2015 and 2016 plans was not published but is assumed to be significant.

- Confirm payable balances with major vendors, and
- Examine transactions involving the capitalization of assets to ensure that those assets provide future benefits.

Risk of internal control issues and the impact of staffing shortages:

Typically, one of the first departments for which costs are trimmed is the accounting workforce, resulting in companies running their operations at less than optimal staffing levels. During the past economic downturn, many companies implemented sizeable layoffs. When the economy started to improve during 2013 through early 2017, those positions were not replaced. Now, in 2017, those same companies have staff levels that are at an all-time low relative to volume of business. That is, companies have learned to maximize their operations with fewer people.

Sizeable layoffs can adversely affect the effectiveness of an entity's internal control for several reasons:

- Employees who are overloaded with work may not have the time to properly complete the necessary tasks, resulting in errors being performed.
- With less staff, there is the greater likelihood that there is a weakness in the segregation of duties.
- The overworking of employees can result in lower employee morale.
- Layoffs of MIS personnel may have an adverse effect on the entity's ability to initiate, process, or record its transactions, or maintain the integrity of the information system.
- Changes to the control environment may alter the control effectiveness and possibly result in a material control weakness.
- With weakened internal control, poor segregation of duties, and lower employee morale due to layoffs and staff reductions, there is greater opportunity for fraud to be committed.

In performing its review of internal control, an auditor must assess the likelihood that a purported internal control system is defective and breached due to a lack of adequate staffing. In particular, emphasis should be placed on weaknesses in key financial and accounting positions and the lack of an appropriate separation of duties.

Risk of outsourcing of certain functions:

U.S. businesses continue to outsource segments of their operations as a means to reduce costs and improve the quality of their business processes. Markets receiving the most U.S. outsourcing include China, Thailand, India, Vietnam, and Mexico, although China has been losing business to the less expensive Cambodia and Laos.

With increasing employee benefit costs, many companies have no choice but to outsource to remain competitive within the U.S. market. In fact, one survey suggests that the decision to outsource is being driven more by significant increases in benefit costs and not labor costs.

All segments of U.S. businesses are susceptible to outsourcing with predominate areas most prone including accounting, human resources, procurement, claims processing, customer service, R&D, manufacturing and other functions. In fact, if you call the customer support department for a software company, odds are that you will be speaking with a person in India rather than the United States.

Service Organization Control (SOC) reports

If a client uses a service organization, transactions that affect the user organization's financial statements are subject to controls that are both physically and operationally apart from the user organization. With the expansion of outsourcing comes certain risks that the auditor should consider including:

- There is less control of business functions, resulting in weaker internal control and security over the system.
- Training at the entity handling the outsourced work may be inadequate.

- Privacy of customer financial information and other data may be compromised thereby exposing the user organization to liability.
- Management's and auditors' understanding and assessment of internal control may need to reflect controls located at the service organization's location at which it does the work.

As a result, the user organization may not be able to administer the internal controls of the service organization. Consequently, in planning the audit of the service organization, the auditor may be required to gain an understanding of the internal control at the service organization that may affect the user organization's financial statements. Part of that understanding is to assess the significance of the service organization's controls to the user organization's internal control. If the user auditor determines that the service organization's controls are significant as compared with the user organization's internal control, the user auditor should gain a sufficient understanding of the service organization's controls to plan the audit. Factors that may affect the significance of the service organization's controls include:

- The nature and materiality of the transactions or accounts affected by the service organization, and
- The degree of interaction between internal control at the user organization and the service organization's controls.

If a user organization outsources a significant process to a service organization, and the user organization is unable to, or elects not to, implement effective internal control over the processes performed by the service organization (e.g., there is a low degree of interaction), the auditor will need to obtain an understanding of the internal controls of the service organization that affect those transactions. That understanding can be obtained in one of two ways:

1. The service auditor can document its understanding of the internal control of the service organization as it relates to the outsourced transactions, or
2. The user auditor can obtain a service auditor's report, that documents the service organization's internal controls.

If, instead, the process outsourced is insignificant or the user organization has implemented an effective internal control over the service organization's processes related to the outsourced transactions, the user auditor is not required to obtain an understanding of the service

organization's internal controls. Instead, the user auditor's responsibility is limited to understanding the user organization's internal controls over the processes performed by the service organization.

SAS No. 122, AU-C Section 402, *Audit Considerations Relating to an Entity Using a Service Organization*, addresses the auditing issues related to the audits of financial statements of an entity (the user organization) that obtains services from another organization (the service organization).

On the service organization side, SSAE No. 16, *Reporting on Controls at a Service Organization*, (AT Section 801) has provided guidance to service auditors who audit service organizations or who rely on Service Organization Controls (SOC) reports.

New SSAE No. 18 replaces SSAE No. 16

In 2016, the Auditing Standards Board issued SSAE No. 18, *Attestation Standards: Clarification and Recodification*. SSAE No. 18 rewrites most of the attestation standards that have been found in SSAE No. 10 through 17 and, in general, is effective for reports dated on or after May 1, 2017.

One change made by SSAE No. 18 is that it supersedes SSAE No. 16, *Reporting on Controls at a Service Organization*, with new AT-C Section 320, *Reporting on an Examination of Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting*. Thus, starting in 2017, auditors of service organizations must follow new AT-C 320 in issuing their 2017 SO reports. User organizations will receive their 2017 SO reports from auditors who follow new AT-C 320.

One of the most important changes that AT-C Section 320 makes to service organizations is relates to subservice organizations. Specifically:

1. A service organization must implement controls to monitor subservice organizations, and include them in the system description.

Examples of monitoring activities found in AT-C 320 include:

- Reviewing and reconciling output reports
- Holding periodic discussions with the subservice organization
- Making regular site visits to the subservice organization
- Testing controls at the subservice organization by members of the service organization's internal audit function,
- Reviewing Type 1 or Type 2 reports on the subservice organization's system, and,
- Monitoring external communications, such as customer complaints relevant to the services by the subservice organization.

2. AT-C 320 defines a subservice organization as:

A service organization used by another service organization to perform some of the services provided to user entities that are likely to be relevant to those user entities' internal control over financial reporting

3. AT-C 320 does not require a service organization to test the internal controls of the subservice organization provided the subservice organization controls are tested as part of its own SOC auditor's report.

What is a subservice organization?

One common example of a subservice organization is a data center to which a service organization outsources some or all of its IT infrastructure.

Typically, data centers already have their own SOC reports. In such cases, the service auditor is not required to test the controls at the data center to the extent the data center's SOC report involves testing of those controls.

Although SSAE 18 does not require that the service auditor test the internal controls of the subservice organization, it does require that the service organization implement controls to monitor the effectiveness of the controls at the subservice organization.

Auditors must understand the following:

1. For auditors of user companies whose clients use service organizations and obtain SOC reports for their clients, the auditors must ensure that the SOC report addresses the subservice organizations that the service organization uses.
2. For service organization auditors who issue SOC reports, those auditors must:
 - a. Consider the SOC reports issued on any subservice organizations (such as data centers), used by service organizations, and
 - b. Ensure that the service organization implements controls to monitor the controls of the subservice organization.

These new rules are effective for SOC reports dated on or after May 1, 2017.

Risk of misapplication of accounting issues related to mergers and acquisitions:

Auditors should become familiar with some of the accounting and auditing issues related to mergers and acquisitions (business combinations).

GAAP for M&A: ASC 805: Business Combinations (ASC 805) (formerly FASB No. 141R) requires use of the acquisition method of accounting for dealing with business combinations. The pooling method was eliminated under the previously issued FASB No. 141. Goodwill and other intangible assets should be recognized in a business combination. Once recorded, intangible assets are accounted for under ASC 350, *Intangibles- Goodwill and Other* (formerly FASB No. 142).

Auditors need to be familiar with ASC 805 which measures a business combination using fair value of assets and liabilities approach. Under this approach, the assets and liabilities of a business combination are recorded at fair value even if it differs from the cost of the transaction. If the collective net fair value of assets and liabilities exceeds their cost, a gain is recorded on the income statement for the bargain purchase discount. This means there is greater risk that companies

continue to inflate the fair value of net assets so that they create an income statement gain at the time of recording a business combination.

Target entity weaknesses in internal control: Just prior to being acquired, a target entity may trim administrative expenses by eliminating positions and functions. In doing so, there may be greater risk of deficiencies in internal control at the date the acquisition is consummated. Auditors should consider such deficiencies when evaluating internal control and assessing control risk.

Greater risk of fraud during a merger: There is a heightened risk that employees will commit fraud when entities merge for several reasons, such as:

- There are typically breakdowns in internal control, a lack of segregation of duties, and reduction in supervision, that provide an opportunity for employees to commit fraud.
- Certain employees may be bitter after the merger, providing the rationalization to commit fraud.

Distorting financial performance during the pre-merger period: Sometimes the entity acquiring another entity may try to manipulate the financial performance of the target entity during the pre-acquisition period. If a target shows a poor financial performance prior to the acquisition, management will find it easier to report improved performance after the acquisition with the resulting spike in reported earnings and stock price. The practice is commonly referred to as “*spring-loading*.”

Auditors should be aware of ways in which entities may attempt to apply spring-loading tactics such as:

1. Writing down investments and fixed assets
2. Accelerating the purchased company's payment of payables
3. Inflating reserves and allowances including:
 - Reserves for merger costs
 - Reserves for inventory obsolescence
 - Pension allowances
 - Restructuring reserves
 - Reserves for workers' compensation and medical insurance
 - Reserves for plant closings and employee terminations
 - Allowance for doubtful accounts on receivables

Some of the above tactics may not necessarily violate GAAP, while others do involve the deliberate inflation of reserves and allowances in direct violation of GAAP.

Concern over compliance with Sarbanes-Oxley Act: A public company may encounter a challenge from the SEC if it acquires a non-public entity that has not complied with Sarbanes-Oxley. For

example, the non-public entity may not have the necessary internal controls in place at the time of acquisition.

Risk of information system cyber-attacks and internal control:

Corporations are experiencing rising cyber-attacks on corporate information technology systems consisting of viruses, worms, zombie spam, and other attacks. There is no indication that these attacks are likely to decline in the future. An auditor should focus on a client's internal control over its systems in assessing internal control. In many cases, management needs to improve its security system.

In performing his or her audit, an auditor should consider performing the following procedures:

1. An auditor should assess whether the company has taken steps to protect against:
 - Inadvertent disclosure of sensitive information to unauthorized parties
 - Computer or transmission disruption
 - Hackers and viruses
 - Electronic frauds
2. An auditor should consider using Computer-Assisted Audit Techniques (CAATs).
3. The auditor may want to test control features that deny unauthorized individuals from being able to authorize or initiate a transaction or to change information already in the system.

The AICPA has created a new Cybersecurity Resource Center to offer guidance to accountants and auditors to assist clients in protecting data and providing assurance services on an entity's cybersecurity.

Risk of improper recording of restructuring charges:

Entities are constantly undergoing restructurings and some may be inclined to increase their liabilities to establish a "rainy day fund" for future periods. Restructuring costs may be incurred in connection with a consolidation, move, relocation, business combination or change in a strategic plan.

Authority for accounting for certain costs associated with exiting an activity, including termination costs, is found in ASC 420, *Exit of Disposal Cost Obligations* (formerly FASB No. 146).

Under ASC 420, costs associated with an exit activity include, but are not limited to:

- Termination benefits
- Costs to terminate a lease
- Costs to consolidate facilities or relocate employees

The general rules of ASC 420 state that a liability for a cost associated with an exit or disposal activity shall be recognized and measured initially at its fair value in the period in which the liability is incurred. Fair value is the amount at which the liability could be settled in a current

transaction between willing parties other than in a forced liquidation. If the fair value cannot be reasonably estimated, the liability is recognized when it can be reasonably estimated.

ASC 420 defines termination benefits as one-time termination benefits and occurs when all of the following criteria have been met:

- Management, having the authority to approve the action, commits to a plan of termination.
- The plan identifies the number of employees to be terminated, their job classifications or functions and their locations, and expected completion date.
- The plan establishes the terms of the benefit arrangement, including the benefits that employees will receive upon termination (including cash payments) in sufficient detail to enable employees to determine the type and amount of benefits they will receive if they are involuntarily terminated.
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

If employees are not required to render service until they are terminated in order to receive termination benefits, or if employees will not be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be recognized and measured at its fair value at the communication date.

If employees are required to render service until they are terminated in order to receive the termination benefits and will be retained to render service beyond the minimum retention period, a liability for the termination benefits shall be measured initially at the communication date based on the fair value of the liability as of the termination date.

- The liability is recognized ratably over the future service period.
- Any change from a revision to either the timing or amount of estimated cash flows over the future service period shall be measured using the credit-adjusted risk-free rate that was used to measure the liability initially. The cumulative effect of the change shall be recognized as an adjustment to the liability in the period of change.
- Present value is appropriate to determine fair value.

Example 1: A company plans to cease operations in a particular location and determines that it no longer needs the 100 employees that currently work in that location. The entity notifies the employees that they will be terminated immediately. Each employee will receive as a termination benefit a cash payment of \$6,000.

Conclusion: Because the employees are not required to render service beyond their termination date in order to receive their termination benefits, a liability shall be recognized and measured at the fair value at the communication date. In this case, the amount is \$600,000 ($\$6,000 \times 100$ employees).

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. What component of engagement risk is associated with the entity's survival and profitability:
 - a. Auditor's audit risk
 - b. Auditor's business risk
 - c. Client audit risk
 - d. Client business risk

2. Which of the following actions is required by AU-C 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99) with respect to the auditor's consideration of fraud:
 - a. Establish an independent expectation of an estimate
 - b. Complete a retrospective review of significant estimates
 - c. Review and test management's process used to develop an estimate
 - d. Review subsequent events and transactions

3. What factor may lead to obsolescence of existing inventory:
 - a. Changes in product design
 - b. Idle capacity
 - c. Reduced prices and profit margins
 - d. Reduced turnover

4. ASC 330, *Inventory* made what change to ARB No. 43, Chapter 4:
 - a. Abnormal amounts of idle facility expense, freight, handling costs, and waste materials (spoilage) are recognized as current period charges
 - b. Normal amounts of idle facility expense, freight, handling costs, and waste materials (spoilage) are recognized as current period charges
 - c. Fixed production overhead is allocated to each unit of production based on actual facility usage
 - d. Companies must capitalize fixed overhead using the greater of actual production or normal capacity in the numerator

5. The Pension Protection Act of 2006:
 - a. Expands and improves defined benefit plans
 - b. Prohibits contributions to under-funded plans from being deferred
 - c. Requires an entity that sponsors one or more defined benefit plans to record the funded status of a benefit plan in its balance sheet

- d. Requires employers to promise additional benefits to employees, regardless of whether they are actually funded
- 6 Which of the following is a method that can be used to understate expenses:
- a. Channel stuffing
 - b. Report peripheral or incidental transactions
 - c. Set aside extra reserves to be reversed to income in future periods
 - d. Understate accounts payable at the end of the year
7. How can sizeable layoffs adversely influence the effectiveness of an entity's internal control:
- a. Customers' financial information may be compromised
 - b. There is less opportunity for fraud to be committed
 - c. Training becomes inadequate
 - d. An expanded work overload may result in more errors

SUGGESTED SOLUTIONS

1. What component of engagement risk is associated with the entity's survival and profitability:
 - a. Incorrect. Auditor's audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.
 - b. Incorrect. Auditor's business risk is the risk of potential litigation costs from an alleged audit failure and the risk of other costs such as fee realization and reputational effects from association with the client.
 - c. Incorrect. Engagement risk consists of client business risk, auditor's audit risk, and auditor's business risk. Client audit risk is not part of engagement risk.
 - d. **Correct. Client business risk is the risk associated with the entity's survival and profitability.**

2. Which of the following actions is required by AU-C 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99) with respect to the auditor's consideration of fraud:
 - a. Incorrect. The requirement to establish an independent expectation of an estimate is found in AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (formerly SAS No. 57). AU-C 540 requires that audit procedures include developing an independent expectation of an estimate to corroborate the reasonableness of the estimate.
 - b. **Correct. AU-C 240 requires an auditor to perform a retrospective review of significant estimates to determine whether there was management bias in establishing those estimates. In performing the retrospective review, the auditor compares the prior year's estimate to the actual outcome related to that estimate.**
 - c. Incorrect. AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (formerly SAS No. 57), not AU-C 240, requires that an auditor review and test the process used by management to develop the estimate.
 - d. Incorrect. AU-C 540 states that audit procedures must include reviewing subsequent events or transactions occurring before the completion of field work. This requirement is not found in AU-C 240 (formerly SAS No. 99) which deals with certain procedures related to fraud.

3. What factor may lead to obsolescence of existing inventory:
 - a. **Correct. A factor that may lead to obsolescence of existing inventory is change in the product design that may lead to a revised product that has limited demand in the marketplace.**
 - b. Incorrect. Idle capacity at a manufacturing facility may result in an overcapitalization of overhead and a valuation in excess of market value, but does not result in obsolescence.
 - c. Incorrect. Reduced prices and profit margins may cause inventories to be valued over market value, but does not lead to obsolescence.
 - d. Incorrect. An unusual increase in inventory balances, reduced turnover, increased backlog and a deterioration in the aging of inventories may be signs that there is excess inventory on hand but not that it is necessarily obsolete.

4. ASC 330, *Inventory* made what change to ARB No. 43, Chapter 4:
 - a. **Correct. ASC 330 requires that abnormal amounts of idle facility expense, freight, handling costs, and waste materials (spoilage) be recognized as current period charges and not capitalized as part of production overhead.**
 - b. Incorrect. Capitalizing normal amounts of idle facility expense, freight, handling costs, and waste materials (spoilage) is not a new change under ASC 330.
 - c. Incorrect. ASC 330 requires that fixed production overhead be allocated to inventories based on the production facilities' normal capacity.
 - d. Incorrect. A key change made by ASC 330 is that it requires companies to capitalize fixed overhead using the greater of normal capacity or actual production in the denominator, not the numerator.

5. The Pension Protection Act of 2006:
 - a. Incorrect. In 2006, Congress passed the Pension Protection Act of 2006 which expands and improves defined *contribution* plans (such as 401(k) plans) and not defined benefit plans, and strengthens the federal pension insurance program.
 - b. **Correct. A key provision of the Act is that it includes the prohibition against contributions to under-funded plans from being deferred.**
 - c. Incorrect. ASC 715, *Defined Benefit Plans*, not the PPA 2006, requires an entity that sponsors one or more defined benefit plans, to record the funded status of a benefit plan, measured as the difference between the fair value of plan assets and the benefit obligation, in its balance sheet.
 - d. Incorrect. PPA 2006 prohibits employers from promising additional benefits to employees until they are actually funded.

6. Which of the following is a method that can be used to understate expenses:
 - a. Incorrect. Channel stuffing is a method to recognize revenue prematurely, not understate expenses.
 - b. Incorrect. Reporting peripheral or incidental transactions, such as nonrecurring gains, is one way that companies may recognize revenue that has not been earned.
 - c. Incorrect. Extra reserves overstate expenses in year one. Ultimately expenses are understated if and when the reserves are reversed in subsequent years.
 - d. **Correct. Understating accounts payable results in understated expenses.**

7. How can sizeable layoffs adversely affect the effectiveness of an entity's internal control:
 - a. Incorrect. Outsourcing could affect privacy of customer financial information and other data, but not layoffs.
 - b. Incorrect. There is greater opportunity for fraud, not less, due to weakened internal control, poor segregation of duties, and lower employee morale from layoffs and staff reductions.
 - c. Incorrect. There is no correlation between training and layoffs.
 - d. **Correct. Employees who are overloaded with work may not have the time to properly complete the necessary tasks, resulting in errors being performed.**

III. Client and Employee Fraud

1. General

Regardless of whether the U.S. economy is in a growth phase or a recession, there continues to be a record number of frauds being committed either in the form of fraudulent financial reporting cases involving management, or misappropriation of assets (theft) involving employees. As management continues to have pressure to produce earnings to satisfy its shareholders and other third parties, fraudulent financial reporting has flourished. Similarly, employee fraud continues to victimize all industries and companies, regardless of whether in the public or nonpublic sectors. Employees use fraud as a means to solve their personal financial pressures from being strapped with record amounts of personal debt and to reimburse themselves for allegedly being overworked in understaffed businesses.

Although the recent cases of fraudulent financial reporting are not as public as Enron, they are just as pervasive. Examples where management has committed fraud include erroneous adjustments made to financial statements, overstated sales and accounts receivable, fabricated inventories and misapplication of generally accepted accounting principles. There have also been cases of side agreements made in which management modified the terms and conditions of billings as a means to conceal overstated sales. Then, of course, there were the high profile cases of Enron, WorldCom and others, that involved use of off-balance sheet entities and overly aggressive capitalization policies.

The reality is that fraud occurs all of the time, regardless of the economy's cycle, and is committed for many different reasons. For example, because of strong economic times, a company may be more inclined to be overly optimistic in connection with earnings estimates. When those estimates do not materialize, management may attempt to artificially inflate earnings.

What we also know is that there is a direct correlation between the tone that management sets at the top of the organization, and the degree of fraud that is committed. Consider the conclusion of the *Report of the National Commission on Fraudulent Financial Reporting*:

"The tone set by top management- the corporate environment or culture within which financial reporting occurs, is the most important factor contributing to the integrity of the financial reporting process.....if the tone set by management is lax, fraudulent financial reporting is more likely to occur."

With respect to SEC companies, companies continue to employ several practices to manage earnings.

Here are the ways in which managed earnings occur:

- Restructuring charges are accelerated or overstated to understate net income.
- Major components of acquisition costs are expensed such as research and development.

- Reserves and allowances are established for a rainy day in years where earnings exceed expectations.
- There are misapplications of accounting principles.
- There is early recognition of revenue.

2. 2016 Report to the Nations on Occupational Fraud and Abuse

In 2016, the Association of Certified Fraud Examiners, (ACFE) issued its bi-annual report entitled *Report to the Nations on Occupational Fraud and Abuse- 2016 Global Fraud Study*.

This report follows similar reports issued by the Association in 1996, 2002, 2004, 2006, 2008, 2010, 2012, 2014, and 2016. The 2016 study is based on 2,127 cases of occupational fraud occurring in more than 100 countries, including the United States.

Although other reports on fraud have been issued in previous years, the 2010 to 2016 ACFE reports are particularly important for two reasons. First, they represent the first global fraud surveys while the previous reports (prior to 2010) focused on United States fraud only. Second, the 2016 report represents the seventh report issued since the passage of Sarbanes-Oxley, thereby offering a series of reports that can follow trends in the post-Sarbanes environment.

The 2016 report focuses on occupational fraud, which is defined as:

"The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."

One key observation noted within the 2016 Report was that the pattern of fraud seemed to operate similarly whether it occurs in Europe, Asia, South America, Canada or the United States.

Before looking at the Report, the author asks that the reader take a quick fraud quizzer by answering the following questions:

FRAUD QUIZ: (answers are at the end of the quiz)

1. Which of the following is the most frequent way in which fraud is detected:
 - a. Tip hotline
 - b. External audit
 - c. Internal audit
 - d. By chance

2. Most fraudsters _____.
 - a. Have a criminal record
 - b. Have no criminal record
 - c. Have bad credit and behavioral problems
 - d. Have both criminal records and bad credit

3. Which of the following is a key behavioral characteristic of a fraudster:
 - a. Living beyond one's means
 - b. Instability
 - c. Complaining about lack of authority
 - d. Past legal problems

4. Which of the following is the most common type of asset misappropriation (theft) in a company:
 - a. Billing schemes
 - b. Expense reimbursements
 - c. Skimming
 - d. Payroll schemes

5. Who commits more frauds:
 - a. Male
 - b. Female
 - c. Either male or female as the percentages are the same
 - d. Male or female dog

6. Which of the following is the profile of the typical fraudster:
 - a. Lower paid male or female employee
 - b. Male, age 20-25, uneducated, with a short-term tenure at the company
 - c. Male, age 41-45, college-educated, with a tenure of one to five years or more.
 - d. Female, age 30-35, uneducated, divorced, with a tenure of more than 10 years.

ANSWERS:

1. a
2. b
3. a
4. a
5. a
6. c

Now let's look at the report entitled *2016 Report to the Nations on Occupational Fraud and Abuse*.

A summary of the Report follows:

- a. The typical organization loses 5% of revenues each year to fraud.
 - If applied to the 2015 estimated Gross World Product (GWP), this translates to a potential projected global fraud loss of nearly \$3.7 trillion (based on GWP of \$74 trillion x 5%).
 - Total losses for U.S. organizations were estimated at \$900 billion for the same period as the Report.¹⁰
- b. The median loss due to fraud was \$150,000 in 2016 while 23% of the cases resulted in losses in excess of \$1 million.
- c. The median amount of time from when the fraud commenced until it was detected was 18 months.
- d. The term occupational fraud encompasses three categories of fraud:

Misappropriation of assets (theft): Involves the theft or misuse of an organization's assets, such as skimming revenues, stealing inventory, or payroll fraud.

- 84% of cases
- Least costly type of fraud at median loss of \$125,000

Fraudulent financial reporting: Consists of falsifying an entity's financial statements, such as overstating revenues and understating expenses and liabilities.

- 10% of cases
- Most costly type of fraud with median loss of \$975,000

Corruption: Involves wrongfully using influence in a business transaction to procure some benefit for the fraudster or others, contrary to their duties to their employer or the rights of another. Examples include kickbacks and engaging in conflicts of interest.

- 35% of cases
- Median loss of \$200,000

Note: AU-C 240 (formerly SAS No. 99) has only two categories of fraud, consisting of misappropriation of assets and fraudulent financial reporting. Corruption falls into either

¹⁰ Estimated based on author's computation. \$18 trillion GDP x 5% = \$900 billion. GWP data obtained from worldbank.org.

category depending on whether the corruption leads to theft of assets or fraudulent financial reporting.

- e. Many cases involve more than one category of occupational fraud.
 - Approximately 32% of the schemes included two or more of the three primary forms of occupational fraud.
- f. The longer a fraud lasts, the more financial damage is caused.
 - Passive detection methods (confession, notification by law enforcement, external audit and by accident) typically take longer to bring fraud to management's attention, which allows the related loss to grow.
 - Proactive detection measures, such as hotlines, management review procedures, internal audits and employee monitoring mechanisms, are vital in catching frauds early and limiting their losses.
- g. Tips are consistently the most common fraud detection method.
 - 39% of all cases were detected by a tip, more than twice the rate of any other detection method.
 - Employees accounted for more than half of all tips that led to the discovery of fraud.
- h. Organizations with hotlines were much more likely to catch fraud by a tip, which is shown to be the most effective way to detect fraud.
 - Organizations with hotlines had frauds that were 41% less costly, and they detected frauds 50% more quickly.
- i. The smallest organizations tend to suffer disproportionately large losses due to occupational fraud.
 - Small businesses are both disproportionately victimized by fraud and notably under-protected by anti-fraud controls, a combination that makes them significantly vulnerable to this threat.
 - While resources available for fraud prevention and detection measures are limited in many small companies, several anti-fraud controls, such as an anti-fraud policy, formal management review procedures and anti-fraud training for staff members, can be enacted with little direct financial outlay.
- j. Industry-specific frauds:

- The banking and financial services, government and public administration, and manufacturing industries continue to have the greatest number of fraud cases reported in our research,
 - The mining, real estate, and oil and gas industries had the largest reported median losses from fraud.
- k. The presence of anti-fraud controls is associated with reduced fraud losses and shorter fraud duration.
- Fraud schemes that occurred at victim organizations that had implemented any of several common anti-fraud controls were significantly less costly and were detected much more quickly than frauds at organizations lacking these controls.
- l. The higher the perpetrator's level of authority, the greater fraud losses tend to be.
- Owners/executives only accounted for 19% of all cases, but they caused a higher median loss of \$703,000.
 - Employees committed 41% of occupational frauds but only caused a median loss of \$65,000
 - Managers committing 37% of frauds with a median loss of \$173,000.
- m. Collusion helps employees evade independent checks and other anti-fraud controls, enabling them to steal larger amounts. As the number of perpetrators increased, losses rose dramatically:
- The median loss in a fraud committed by:
- A single person: \$85,000
 - Two perpetrators: \$150,000,
 - Three perpetrators: \$220,000
 - Four perpetrators: \$294,000, and
 - Five or more perpetrators: greater than \$633,000.
- n. Approximately 77% of the frauds were committed by individuals working in one of seven departments:
- Accounting
 - Operations
 - Sales
 - Executive/upper management
 - Customer service
 - Purchasing and

- Finance
- o. It takes time and effort to recover the money stolen by perpetrators, and many organizations are never able to fully do so.
- 58% of the victim organizations did not recover any of their losses due to fraud.
 - Only 12% had made a full recovery.
- p. External audits are among the *least effective* controls in combating occupational fraud.
- External audits were the primary detection method in just 4% of the fraud cases reported, compared to the 6% of cases that were detected by accident.
 - Although the use of independent financial statement audits was associated with reduced median losses and durations of fraud schemes, these reductions were among the smallest of all of the anti-fraud controls analyzed.
 - While independent audits serve a vital role in organizational governance, data indicates that they should not be relied upon as organizations' primary anti-fraud mechanism.
- q. Many of the most effective anti-fraud controls are being overlooked by a significant portion of organizations.
- Proactive data monitoring and analysis was used by only 36% of the victim organizations in our study, but the presence of this control was correlated with frauds that were 54% less costly and 50% shorter in duration.
 - Other less common controls, including surprise audits, a dedicated fraud department or team and formal fraud risk assessments, showed similar associations with reductions in fraud damage.
- Note:** When determining how to invest anti-fraud dollars, management should consider the observed effectiveness of specific control activities and how those controls will enhance potential fraudsters' perception of detection.
- r. Most occupational fraudsters exhibit certain behavioral traits that can be warning signs of their crimes, such as:
- Living beyond their means or
 - Having unusually close associations with vendors or customers.
- Note:** In 91% of the cases reviewed, at least one common behavioral red flag was identified before the fraud was detected.
- s. The vast majority of occupational fraudsters are first-time offenders:

- Only 5% had been convicted of a fraud-related offense prior to committing the crimes in our study.
 - 92% of fraudsters had never previously been punished or terminated by an employer for fraud-related conduct.
- t. While background checks can be useful in screening out some bad applicants, they might not do a good job of predicting fraudulent behavior.
- Most fraudsters work for their employers for years before they begin to steal, so ongoing employee monitoring and an understanding of the risk factors and warning signs of fraud are much more likely to identify fraud than pre-employment screening.

Specific details from the 2016 Report:

In the following section, the author has extracted from the 2016 Report excerpts of key trends and other information that is pertinent to the detection and prevention of occupational fraud:

| <i>Frauds by Method</i> | | |
|---------------------------------|--------------------|-------------|
| <u>Type of fraud</u> | <u>% cases</u> | |
| | <u>2014</u> | <u>2016</u> |
| Asset misappropriation (theft) | 85% | 84% |
| Corruption schemes | 37% | 35% |
| Fraudulent financial statements | 10% | 10% |
| <u>Type of fraud</u> | <u>Median loss</u> | |
| | <u>2014</u> | <u>2016</u> |
| Asset misappropriation (theft) | \$130,000 | \$125,000 |
| Corruption schemes | 200,000 | 200,000 |
| Fraudulent financial statements | 1,000,000 | 975,000 |

| <i>Asset Misappropriations - By Type</i> | | | | |
|--|-----------------------|--------------------|-----------------------|--------------------|
| | <u>2014</u> | | <u>2016</u> | |
| | <u>% of all cases</u> | <u>Median loss</u> | <u>% of all cases</u> | <u>Median loss</u> |
| Involving cash receipts | | | | |
| Skimming | 12% | \$40,000 | 12% | \$53,000 |
| Cash larceny | 9% | 50,000 | 8% | 90,000 |
| Involving fraudulent cash disbursements | | | | |
| <i>Billing schemes</i> | 22% | 100,000 | 22% | 100,000 |
| Check tampering | 11% | 120,000 | 11% | 158,000 |
| Expense reimbursements | 14% | 30,000 | 14% | 40,000 |
| Payroll schemes | 10% | 50,000 | 9% | 90,000 |
| Cash register disbursement schemes | 3% | 20,000 | 3% | 30,000 |
| Cash on hand misappropriations | 12% | 18,000 | 12% | 25,000 |
| Involving non-cash assets: | | | | |
| Non-cash misappropriations including inventory theft | 21% | 95,000 | 19% | 70,000 |

Categories of fraudulent cash disbursements noted in the 2016 Report include:

1. Billing schemes: Employee submits invoices for payment by the organization that are for fictitious goods or services, inflated amounts, or for personal purchases.
2. Check tampering: Employee or other perpetrator converts an organization's funds by forging or altering a check on one of the organization's bank accounts, or by stealing a check that was issued to another payee.
3. Expense reimbursement schemes: Employee makes a false claim for reimbursement of fictitious or inflated business expenses.
4. Payroll schemes: Employee has the victim organization issue payment for false compensation or to a fictitious employee.
5. Register disbursement schemes: Employee makes false entries on a cash register to conceal the fraudulent removal of currency.
6. Cash on hand misappropriations: Employee fraudulently voids a sale on the cash register and steals cash.

| <i>Duration of Fraud by Scheme Type</i> | |
|---|-------------|
| | <u>2016</u> |
| <u>Involving cash receipts</u> | |
| Skimming | 24 |
| Cash larceny | 20 |
| <u>Involving fraudulent cash disbursements</u> | |
| <i>Billing schemes</i> | 24 |
| <i>Check tampering</i> | 24 |
| Expense reimbursements | 24 |
| <i>Payroll schemes</i> | 24 |
| Cash register disbursement schemes | 13 |
| Cash on hand misappropriations | 15 |
| Non-cash misappropriations including inventory theft | 15 |
| Fraudulent financial statements | 24 |
| Corruption | 18 |

Observation: Notice how long it takes to detect a fraud, with a detection period ranging from 12 to 24 months.

| <i>Initial Method of Fraud Detection</i> | | |
|---|-------------|-------------|
| | <u>2014</u> | <u>2016</u> |
| Tips (whistleblowing) from all sources | 42% | 39% |
| Management review | 16% | 13% |
| Internal audit | 14% | 17% |
| By accident | 7% | 6% |
| Account reconciliation | 7% | 6% |
| Document examination | 4% | 4% |
| External audit | 3% | 4% |
| Internal controls | 1% | 1% |

| <i>Source of Tips</i> | | |
|-----------------------|-------------|-------------|
| | <u>2014</u> | <u>2016</u> |
| Tip from employees | 48% | 52% |
| Tip from customer | 22% | 18% |
| Anonymous tip | 15% | 14% |
| Tip from vendor | 7% | 10% |
| Other | 13% | 13% |

Note: Growth of anonymous tips from 12% in 2012 to 14-15% in 2014 and 2016, may be due to whistleblowers not wanted to be subject to retaliation by employers. Note further how far down the list detection by the external audit is at 4%, which is lower than 6% by accident.

| <i>Fraudulent by Type of Organization</i> | | | | |
|---|----------------|--------------------|----------------|--------------------|
| | 2014 | | 2016 | |
| <u>Company type</u> | <u>% cases</u> | <u>Median loss</u> | <u>% cases</u> | <u>Median loss</u> |
| Private companies | 38% | \$160,000 | 38% | \$180,000 |
| Public companies | 28% | 200,000 | 29% | 178,000 |
| Government | 15% | 90,000 | 19% | 109,000 |
| Not-for-profits and other | 19% | 108,000 | 14% | 96,000 |

| <i>Fraudulent by Size of Organization</i> | | | | |
|---|----------------|--------------------|----------------|--------------------|
| | 2014 | | 2016 | |
| <u>Number of employees</u> | <u>% cases</u> | <u>Median loss</u> | <u>% cases</u> | <u>Median loss</u> |
| <100 (small cap) | 28% | \$154,000 | 30% | \$150,000 |
| 100- 999 | 24% | 128,000 | 22% | 186,000 |
| 1,000- 9,999 | 28% | 100,000 | 28% | 100,000 |
| 10,000 plus | 20% | 160,000 | 20% | 150,000 |

| <i>Methods of Fraud: By Size of Victim Organization</i> | | |
|---|--------------------------|------------------------|
| | <u><100 employees</u> | <u>100 + employees</u> |
| Corruption | 30% | 40% |
| Asset misappropriations | | |
| Skimming | 20% | 9% |
| Cash larceny | 14% | 7% |
| Billing schemes | 27% | 21% |
| Check tampering | 20% | 8% |
| Expense reimbursements | 17% | 14% |
| Payroll schemes | 14% | 6% |
| Cash register disbursement schemes | 4% | 2% |
| Cash on hand misappropriations | 16% | 10% |
| Non-cash misappropriations and inventory theft | 19% | 19% |
| Fraudulent financial statements | 12% | 8% |

| <i>Primary Weakness that Existed During the Fraud- Asset Misappropriation</i> | |
|---|----------------|
| | <u>% cases</u> |
| Lack of internal controls | 30% |
| Lack of management review | 20% |
| Override of existing controls | 20% |
| Poor tone at the top | 10% |
| Lack of competent personnel in oversight role | 6% |
| Lack of independent audit/ checks | 4% |

| <i>Anti-Fraud Measures in Place at the Time Fraud was Committed</i> | | |
|--|---------------------------|------------------------|
| | <u>< 100 employees</u> | <u>100 + employees</u> |
| External audit | 56% | 94% |
| Code of conduct | 54% | 91% |
| Internal audit | 39% | 88% |
| External audit of internal control (Section 404) | 37% | 80% |
| Management certification of financial statements | 43% | 84% |
| Independent audit committee | 28% | 77% |
| Management review | 40% | 75% |
| Anonymous hotline | 26% | 74% |
| Fraud training for managers/executives | 24% | 62% |
| Fraud training for employees | 23% | 63% |
| Surprise audits | 18% | 46% |
| Job rotation | 10% | 23% |
| Note: A key distinction in the types of anti-fraud measures found in larger versus smaller companies is the use of an employee hotline. 67 percent of larger companies had employee hotlines to report fraud, while only 18 percent of smaller companies had a hotline. | | |

| <i>Median Loss Reduction Based on Existence of Anti-Fraud Controls</i> | | | | |
|--|------------------------------------|---|--|--------------------|
| <u>Control in effect</u> | <u>% cases implemented control</u> | <u>Median fraud loss with control in effect</u> | <u>Median fraud loss without control in effect</u> | <u>% reduction</u> |
| Data monitoring/analysis | 37% | \$92,000 | \$200,000 | 54% |
| Tip hotline | 60% | 100,000 | 200,000 | 50% |
| Employee support programs | 56% | 100,000 | 183,000 | 45% |
| Management review of IC | 65% | 100,000 | 200,000 | 50% |
| Surprise audits | 38% | 100,000 | 195,000 | 49% |
| Fraud training for managers and executives | 51% | 100,000 | 190,000 | 47% |
| Fraud training for employees | 52% | 100,000 | 188,000 | 47% |
| Formal fraud risk assessment | 39% | 100,000 | 188,000 | 47% |
| Job rotation/mandatory vacation | 19% | 89,000 | 170,000 | 48% |
| Code of Conduct | 81% | 120,000 | 200,000 | 40% |
| Anti-fraud policy | 50% | 100,000 | 175,000 | 43% |
| External audit of internal control | 68% | 105,000 | 200,000 | 48% |
| Internal Audit | 74% | 123,000 | 215,000 | 43% |
| Independent audit committee | 63% | 114,000 | 180,000 | 37% |
| External audit of FS | 82% | 150,000 | 175,000 | 14% |
| Management certification of FS | 72% | 104,000 | 205,000 | 49% |
| Rewards to whistleblowers | 12% | 100,000 | 163,000 | 39% |

| <i>Duration of Fraud Based on Presence of Anti-Fraud Controls</i> | | | |
|---|---------------------------------|-------------------------|----------------------------|
| | <u># months to detect fraud</u> | | |
| | <u>Control not in place</u> | <u>Control in place</u> | <u>% reduction in time</u> |
| Data monitoring/analysis | 24 months | 12 months | 50% |
| Hotline | 24 months | 12 months | 50% |
| Surprise audits | 24 months | 12 months | 50% |
| Management review | 24 months | 12 months | 50% |
| Code of Conduct | 24 months | 13 months | 46% |
| Job rotation/mandatory vacations | 18 months | 10 months | 44% |
| Anti-fraud policy | 21 months | 12 months | 43% |
| Fraud training | 20 months | 12 months | 40% |
| Rewards of whistleblowers | 18 months | 11 months | 39% |
| External audit of FS | 24 months | 15 months | 38% |
| Employee support programs | 18 months | 12 months | 33% |

Note: Having certain anti-fraud controls in place can significantly reduce detection time. In particular, data monitoring, using a hotline, surprise audits and management review are the controls that reduce detection time by about 50%. Implementing an external audit is one of the least effective control reducing detection time by only 38%.

| <i>Position of Fraud Perpetrator</i> | | |
|--------------------------------------|----------------|--------------------|
| <u>Position</u> | <u>2016</u> | |
| | <u>% cases</u> | <u>Median loss</u> |
| Owner/executive | 19% | \$703,000 |
| Manager | 37% | 173,000 |
| Employee | 41% | 65,000 |

| <i>Duration of Fraud Based on Position</i> | |
|--|------------------------------|
| <u>Position</u> | <u># months to detection</u> |
| Owner/executive | 24 |
| Manager | 18 |
| Employee | 12 |

| <i>Median Loss Based on Number of Perpetrators</i> | |
|--|--------------------|
| <u>Number of Perpetrators</u> | <u>Median Loss</u> |
| 1 | \$85,000 |
| 2 | 150,000 |
| 3 | 220,000 |
| 4 | 294,000 |
| 5 or more | 633,000 |

***Correlation Between Perpetrator's Tenure,
Frequency, and Median Fraud Loss***

| <u>Tenure</u> | <u>% Cases</u> | <u>Median fraud loss</u> |
|--------------------|--------------------|------------------------------|
| Less than 1 year | 8% | \$49,000 |
| 1 to 5 years | 42% | 100,000 |
| 6 to 10 years | 27% | 210,000 |
| More than 10 years | 23% | 250,000 |

Note: There is a direct correlation between the tenure of the perpetrator and the amount of fraud loss. The correlation is likely to be the result of 1) the perpetrator being in a higher level of authority and 2) the employee having a greater degree of trust with his/her superiors and co-workers.

Frequency and Median Loss of Fraud Based on Age of Perpetrator

| <u>Age</u> | <u>2016</u> | |
|------------|-----------------------|------------------------|
| | <u>% of cases</u> | <u>Median Loss</u> |
| > 60 | 3% | \$630,000 |
| 56-60 | 5% | 258,000 |
| 51-55 | 8% | 280,000 |
| 46-50 | 15% | 250,000 |
| 41-45 | 19% | 250,000 |
| 36-40 | 20% | 100,000 |
| 31-35 | 15% | 100,000 |
| 26-30 | 11% | 50,000 |
| <26 | 5% | 15,000 |

Frequency and Median Loss of Fraud Based on Gender of Perpetrator

| | <u>2014</u> | | <u>2016</u> | |
|--------|-----------------------|------------------------|-----------------------|------------------------|
| | <u>% of cases</u> | <u>Median Loss</u> | <u>% of cases</u> | <u>Median Loss</u> |
| Male | 67% | \$185,000 | 69% | \$187,000 |
| Female | 33% | 83,000 | 31% | 100,000 |

Perpetrators' Criminal Histories

| | <u>% cases</u> |
|--|----------------|
| Had never been charged or convicted of a crime | 88% |
| Had prior convictions | 5% |
| Charged but not convicted and other | 6% |

| <i>Perpetrators' Employment Histories</i> | |
|---|----------------|
| | <u>% cases</u> |
| Had never been punished or terminated | 83% |
| Had previously been punished | 9% |
| Previously terminated and other | 8% |

| <i>Behavioral Red Flags Present During Fraud Scheme- United States</i> | | |
|--|------------------------|------------------------|
| <u>Behavioral red flag:</u> | 2014 <u>% cases</u> | 2016 <u>% cases</u> |
| Living beyond means | 43% | 46% |
| Financial difficulties | 33% | 30% |
| Unusual close association with vendor/customer | 22% | 20% |
| Control issues, unwillingness to share duties | 21% | 15% |
| “Wheeler-dealer” attitude | 18% | 15% |
| Divorce/family problems | 17% | 13% |
| Irritability, suspiciousness, defensiveness | 15% | 12% |
| Past employment related problems | 9% | 7% |
| Addiction problems | 12% | 10% |
| Complaining about inadequate pay | 8% | 9% |
| Refusal to take vacations | 9% | 8% |
| Excessive pressure from within organization | 8% | 5% |
| Past legal problems | 6% | 6% |
| Excessive family/peer pressure for success | 6% | 5% |
| Complaining about lack of authority | 7% | 4% |
| Instability | 6% | 4% |
| Note: Signs of a fraud perpetrator include an employee who is under financial pressure by living beyond his/her means and having other financial difficulties, among other signs. | | |

| <i>Types of Background Checks</i> | |
|---|----------------|
| | <u>% cases</u> |
| Employment history check | 80% |
| Criminal check | 73% |
| Credit check | 38% |
| Note: Companies continue to perform the wrong kind of checks consisting of employment and criminal checks. The 2016 Study shows that most perpetrators had not been terminated previously nor did they have a criminal record. Instead, the greatest correlation of behavior and committing fraud is that many of the fraudsters were under personal financial stress which may be uncovered by doing a credit check. Conducting a credit check is the least common check that is done by companies of their employees, but perhaps, the most effective. | |

| <i>Cases Referred to Law Enforcement</i> | |
|--|----------------|
| | <u>% cases</u> |
| Yes | 59% |
| No | 41% |
| Note: In 59% of the cases, the victim organization referred the case to law enforcement authorities for criminal prosecution. | |

| <i>Results of Cases Referred to Law Enforcement</i> | |
|---|----------------|
| | <u>% cases</u> |
| Plead guilty or no contest | 57% |
| Convicted at trial | 20% |
| Declined to prosecute | 13% |
| Other | 8% |

| <i>Recovery of Losses</i> | |
|--|----------------------------|
| | <u>% of loss recovered</u> |
| No recovery | 58% |
| 1-25% | 12% |
| 26-50% | 9% |
| 51-75% | 4% |
| 76-99% | 5% |
| 100% | 12% |
| Note: 58% of victims did not recover any losses which is consistent with previous research by the ACFE. In contrast, only 12% of victims made a full recovery through restitution, insurance claims or other means. | |

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. Which category of fraud consists of wrongfully using influence in a business transaction to procure some benefit for the fraudster or others, contrary to their duties to their employer or the rights of another:
 - a. Corruption
 - b. Fraudulent financial reporting
 - c. Misappropriation of assets
 - d. Payroll schemes

2. According to the *2016 Report to the Nation on Occupational Fraud and Abuse*, which category of fraudulent cash disbursements involves the employee submitting invoices for payment by the organization that are for fictitious goods or services, inflated amounts, or for personal purchases:
 - a. Billing schemes
 - b. Check tampering
 - c. Expense reimbursement schemes
 - d. Register disbursement schemes

3. In the *2016 Report to the Nation on Occupational Fraud and Abuse*, it was reported that the external auditor initially detected fraud in ____ of the cases.
 - a. 17%
 - b. 4%
 - c. 13%
 - d. 39%

SUGGESTED SOLUTIONS

1. Which category of fraud consists of wrongfully using influence in a business transaction to procure some benefit for the fraudster or others, contrary to their duties to their employer or the rights of another:
 - a. **Correct. Corruption is defined as the wrongful use of influence in a business transaction to procure a benefit for the fraudster or others, contrary to their duties to their employer or the rights of another.**
 - b. Incorrect. Fraudulent financial reporting is falsifying an entity's financial statements, such as overstating revenues and understating expenses and liabilities.
 - c. Incorrect. Misappropriation of assets (theft) involves the theft or misuse of an organization's assets, such as skimming revenues, stealing inventory, or payroll fraud.
 - d. Incorrect. Payroll schemes is a category of fraudulent cash disbursements, which falls under the category of cash misappropriation.

2. According to the *2016 Report to the Nation on Occupational Fraud and Abuse*, which category of fraudulent cash disbursements involves the employee submitting invoices for payment by the organization that are for fictitious goods or services, inflated amounts, or for personal purchases:
 - a. **Correct. Billing schemes involve the employee submitting invoices for payment by the organization that are for fictitious goods or services, inflated amounts, or for personal purchases.**
 - b. Incorrect. Check tampering involves an employee or other perpetrator converting an organization's funds by forging or altering a check on one of the organization's bank accounts or by stealing a check that was issued to another payee.
 - c. Incorrect. Expense reimbursement schemes involve an employee making a false claim for reimbursement of fictitious or inflated business expenses.
 - d. Incorrect. Register disbursement schemes involve an employee making false entries on a cash register to conceal the fraudulent removal of currency.

3. In the *2016 Report to the Nation on Occupational Fraud and Abuse*, it was reported that the external auditor initially detected fraud in _____ of the cases.
 - a. Incorrect. In 17% of the cases, the fraud was detected through internal audit, not external audit, making the answer incorrect.
 - b. **Correct. Only in 4% of the cases did the external auditor initially detect the fraud. This fact supports the conclusion that it is difficult for an external auditor to detect fraud based solely on the audit procedures performed.**
 - c. Incorrect. In 13% of the cases, the fraud was detected by management review, and not the external audit, making the answer incorrect.
 - d. Incorrect. In 39% of the cases, fraud was detected by a tip, and not by external audit, making the answer incorrect.

3. Types of Fraud

Fraud is a legal concept that expands well beyond the responsibilities of auditors. An auditor is only responsible for *material misstatements* to the financial statements, whether caused by error or fraud. Thus, an auditor is *not responsible for immaterial fraud*, that is, fraud that has no material impact on the financial statements.

What differentiates fraud from an error is intent. Fraud is an *intentional misstatement*, while an error is *unintentional*.

Fraud = Intentional Misstatement
Error = Unintentional Misstatement

Effective December 21, 2012, SAS No. 122, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, replaces SAS No. 99 and changes the definition of fraud to the following:

“An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.”

The previous definition of fraud found in SAS No. 99 is:

“An intentional act that results in a material misstatement in financial statements that are the subject to an audit.”

Other than change the definition of fraud, AU-C 240 does not make any substantive changes to SAS No. 99.

Observation: Intent may be difficult to determine, particularly in situations involving accounting estimates or use of accounting principles. For example, is the use of an unreasonable estimate or aggressive accounting principle intentional or simply poor judgment? Technically, the auditor is not concerned about intent. The key in the end is whether there is a material misstatement in the financial statements, regardless of whether it was done intentionally (fraud) or unintentionally (an error). Yet, if a material misstatement is deemed to be intentional, instead of an isolated unintentional error, this information should enhance the auditor’s professional skepticism to the fact that other intentional misstatements might exist.

There are *two types* of misstatements due to fraud:

- Fraudulent financial reporting (“cooking the books”)
- Misappropriation of assets (theft or defalcation)

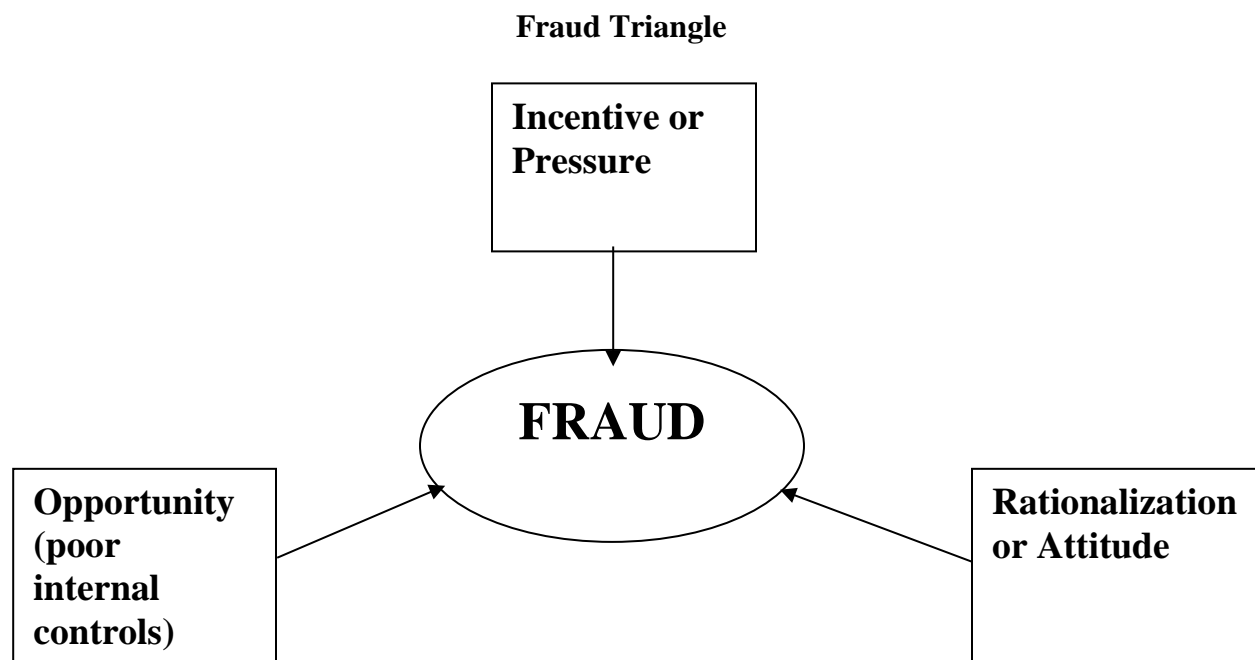
Note: In recent years, there have been a significant number of highly publicized cases of alleged or actual management fraud. Reasons for fraud depend on the type of fraud involved. Fraudulent financial reporting is likely to be performed by higher-level management who has a stake in

altering the financial statement results. Alternatively, misappropriation of assets (e.g., theft) can be performed at all levels from the lowest employment position to the highest. Statistically, 80% of all fraud consists of the misappropriation of assets, while only 20% is from fraudulent financial reporting. Regarding employee theft, reasons for committing the crime vary from employee revenge for corporate restructurings, to changes in technology making it easier to conceal fraud.

Conditions needed for fraud - the fraud triangle:

Three conditions usually are present when a fraud occurs. These three conditions are commonly referred to by fraud examiners as the *fraud triangle*.

1. Incentive or Pressure: Management or other employees have an incentive or are under pressure (financial or otherwise), which provides a reason to commit fraud.
2. Opportunity: Circumstances exist, such as the absence of controls, ineffective controls, or the ability of management to override controls, that provide an opportunity for a fraud to be perpetrated.
3. Rationalization or attitude: Individuals involved in the fraud are able to rationalize committing the fraud. Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.



Although the three conditions of the fraud triangle are typically present in a perpetration of a fraud, there are circumstances when only one, or even two of the conditions may be present.

Examples:

1. An employee who is under personal financial pressure and is able to rationalize committing a fraud, is able to perpetrate a fraud even though there is a strong system of internal control. The employee used a narrow breach in the system of internal control.
2. A company that has a poor system of internal control is victimized by an employee fraud. The employee, who has no incentive/pressure to commit the fraud and appears not to possess a rationalization/attitude to commit a fraud, perpetrates a fraud because he or she is tempted by his or her ability to commit the fraud within a poor system of internal control.
3. A manager/owner has an incentive/pressure to achieve a certain income level to avoid triggering a loan default, where there is no indication of the presence of the other two conditions.

The three conditions of fraud need to be considered in light of the size, complexity and ownership attributes of the entity.

For example a larger entity might have controls that constrain improper conduct by management including:

- Existence of an audit committee
- Use of an internal audit function
- Existence and enforcement of a formal code of conduct

Conversely, a smaller, usually closely held entity may not have any of the same constraints placed on the management of a larger entity, as noted above. Rarely is an audit committee or internal audit function in use. Moreover, a formal code of conduct may not only be non-existent, but also may be discouraged for stifling the entrepreneurial environment. Instead of having formal controls, a smaller entity might have other attributes such as developing a culture that emphasizes integrity and ethical behavior.

In such situations, the auditor should be careful not to be fooled into a sense of security.

Notes: An otherwise honest individual can still commit fraud in an environment that imposes sufficient pressure on him or her. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.

Although all three conditions of the fraud triangle may help contribute to the perpetration of fraud, the most important condition is opportunity. Where there is incentive and rationalization to commit a fraud, such a fraud cannot occur unless the system of internal control allows it to happen. The number one reason why fraud occurs is due to poor internal controls, thus creating the opportunity for it to occur.

Note: According to the *2016 Report to the Nation, Occupational Fraud and Abuse* (Association of Certified Fraud Examiners), in 50% of the frauds examined, either poor internal controls or controls that were in place but were overridden, were cited as the primary reason why the fraud occurred.

The fraud triangle in the 2017 economic climate:

The 2017 economic climate is rife for fraud in that the three conditions of the fraud triangle exist in many organizations.

Incentive or pressure: Today there is tremendous incentive and pressure to commit fraud. In particular, previous years' high layoffs coupled with the pressure for organizations to achieve more output with fewer staff, creates pressure on employees. Along with the incentive and pressure on the job, those same employees may feel personal pressure from high levels of personal debt and defaulted mortgages.

Opportunity: With smaller accounting and other staffs, clearly internal business environments may provide the opportunity for employees and management to commit fraud.

Rationalization or attitude: It is easier for an employee to rationalize the perpetration of a fraud when he or she is being squeezed inside as well as outside the organization. Pressure to increase earnings means the employee is performing extraordinary efforts for the benefit of the shareholders with little to trickle down to the employees. Moreover, with the elimination of bonuses and contributions to retirement plans within some organizations, employees feel betrayed and can more easily justify committing a fraud.

a. Fraudulent financial reporting:

Fraudulent financial reporting involves the intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented in accordance with GAAP (or an other comprehensive basis of accounting, if used).

Fraudulent financial reporting is accomplished in several ways:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation in or intentional omission from the financial statements of events, transactions, or other significant information, and
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting does not have to occur as some sort of grand scheme or conspiracy. Instead, it may be the result of management rationalizing the appropriateness of a material misstatement as merely an aggressive, rather than an indefensible, interpretation of complex accounting rules. Or, management might argue that a misstatement is temporary and will reverse or correct itself in future reporting periods.

Example: Company X is having a terrible year and expects to incur a sizeable loss. Management believes the loss is temporary due to the economic downturn. X has already discussed the expected loss with the bank who accepts it as an aberration for one year only. The bank expects a company turnaround next year.

Historically, in computing its allowance for bad debts for its trade receivables, the company has computed the allowance balance based on 100% of receivables over 90 days old. This year, management wished to place a “cushion” in the allowance by including not only 100% of over-90-day balances, but another 20% of over-60-day balances.

When the auditor asks management why they are computing the allowance to include a portion of the over-60-day receivables, management states that it wants to “clean up” its balance sheet by being conservative in the event some of the over-60-day balances are uncollectible. At the balance sheet date, there is no indication that any of the over-60-days receivables are uncollectible even though a large percentage has not been collected under dated payment terms.

The auditor likes the fact that management is being prudent by including a higher-than-needed balance in the allowance account.

Does the above scenario include a misstatement due to fraudulent financial reporting?

Response: Yes. This is a subtle example of fraudulent financial reporting involving managed earnings. Yet, on the surface, one might argue that it is merely an aggressive use of an estimate.

The easiest way for management to manipulate earnings is by over-inflating reserves and allowance accounts, such as the allowance for bad debts and reserves for obsolete inventory.

By being “conservative” with an inflated allowance account with full knowledge of the fact that the balance is excessive, management is doing nothing more than setting up a “rainy day fund.” That is, management has in its allowance account excess that can be reversed in future years to augment earnings. The most likely time for managed earnings to occur is in a loss year in which management chooses to increase the loss incurred and, instead, to shift income to future years in which it might need it.

The signs of possible fraudulent financial reporting

Even in a growing economy, there is pressure on management to achieve and maintain financial results to appease analysts, banks, investors and other third parties. As a result, there may be heightened risk that fraudulent financial reporting might exist and not be detected by the auditors.

Auditors have the responsibility to obtain reasonable evidence that the financial statements are free from material misstatements, including those resulting from fraud. SAS No. 122, AU-C 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99), provides a list of risk factors that an auditor should consider in assessing fraud risk. The list includes:

- A highly leveraged entity is in violation of loan covenants
- An entity is dependent on an IPO to obtain funding
- An entity is unable to obtain and maintain financing
- There is evidence of liquidity problems
- There are changes in accounting policies and assumptions to less conservative ones
- There are profits but no cash flow
- A high percentage of management's compensation is linked to earnings and stock appreciation
- There has been a significant change in members of senior management or the board of directors

Auditors should have heightened skepticism that fraud might exist in situations in which some of the previous factors are present.

In the AICPA *Audit Risk Alert*, reference is made to some of the more common types of financial statement fraud schemes encountered by the FBI in recent cases which include:

| Common Types of Financial Statement Fraud Noted by the FBI | |
|---|---|
| Type of Fraud | Description |
| Phony Sales | Creating invoices for products that were never sold, often made to foreign companies so that auditors have difficulty verifying the legitimacy of the sale. |
| Parked Inventory Sales | Loading trucks full of inventory on the last day of the year and “parking” the inventory in a nearby parking lot. Because the goods have been “shipped” away from the building, the company fraudulently records a sale. In reality, the customer has merely ordered the product for shipment at a later date. |
| Channel Stuffing | Shipping products that are not needed by customers. Later on, when the customer complains that the goods were not ordered, the customer is given deep discounts or returns are authorized. The returns or rebates are recorded in the future period while revenue is overstated in the current period. The transactions are repeated in the next period to offset the reversal of the returns and rebates given from the previous period. |
| Swap Transactions | Two companies exchange their products and payments for the sole purpose of increasing each other’s revenues. |
| Side Letter Agreements | A sales transaction in which a company issues a right of return or contingency letter to a customer as a condition of sale. The letters usually give the customer the right to return any products it cannot sell. A fraud exists because the sale must be reversed and the auditor has not been informed about the side letter. |
| Accelerated Revenue | Recording sales in the current period even though they relate to future periods. In some cases, the scheme is consummated by backdating sales contracts or other agreements. |
| <i>Source: AICPA Audit Risk Alert, as modified by the Author.</i> | |

When it comes to fraudulent financial reporting, in many instances companies “cook the books” with more finesse than simply altering financial statements. In fact, manipulating financial statements can be done with such subtlety that the auditor may not even know it is being done.

Let’s look at three ways in which management can “cook the books.”

- *Most extreme way:* Actually commit fraudulent financial reporting such as overstating inventories or revenues- illegal.

- Moderate way: Stretch accounting rules to the limit- may or may not be illegal.
- Very modest way: Follow the accounting rules, but seek ambiguous loopholes in the GAAP rules- legal but may not be ethical.

Many auditors may look for the obvious most extreme means by which management commits fraudulent financial reporting, such as by overstating revenue and/or inventories. Yet, the more subtle ways of simply stretching accounting rules or finding GAAP loopholes can have just as great an impact on distorting financial statements. There is also a greater incentive for management to simply stretch the accounting rules in that they are unlikely to be charged with fraud either civilly or criminally.

By way of example, following are some of the balance sheet accounts that management can manipulate by over or understating them, without committing fraud:

Allowance accounts and liabilities that can be easily overstated:

- Allowance for doubtful accounts
- Allowance for obsolete inventory
- Liability for uncertain tax positions (FIN 48)
- Deferred income tax asset valuation account

Asset valuations that can easily be manipulated:

- Goodwill- impairment writedowns
- Intangible assets with indefinite lives- impairment writedowns

Observation: The FASB continues to move GAAP toward a principles-based system under which GAAP will be determined based on broader principles and fewer rules. It will be interesting to see how auditors are able to function in such an environment. Without the current rules-based GAAP, management will be able to stretch the rules and find numerous GAAP loopholes to justify their interpretation of GAAP. In such an environment, auditors will be placed in the difficult position of not having the authoritative tools (e.g., specific GAAP rules) to challenge management's position.

The Crazy Eddie Ripoff

Eddie Antar, better known as Crazy Eddie was a consumer electronics retailer in New York, New Jersey and Connecticut who engineered a \$120 million theft with his family members. Eddie fooled the auditors and was ultimately caught, spending time behind bars.

In his article, *So That's Why It's Called a Pyramid Scheme*, author Joseph T. Wells uses the Crazy Eddie case to illustrate the different types of fraud commonly committed. He breaks them down into five categories:

| Most common fraud method | What Crazy Eddie did | How the auditor could have caught it |
|--|--|--|
| <p>1. Fictitious revenues: Companies create fictitious revenues for sales that did not occur.</p> | <p>Eddie created fictitious invoices showing merchandise sales to three major suppliers who colluded in the transaction. When the auditors confirmed the receivables, the suppliers confirmed that the balances were accurate.</p> | <p>Analytical procedures might have caught this fraud including an analysis of sales at the end of the year and shipping documents.</p> |
| <p>2. Fraudulent inventory valuations: Inflating inventories that do not exist or overvaluing inventories that do exist are two of the most common methods of committing inventory fraud.</p> | <p>Eddie overvalued his inventory by \$80 million by borrowing merchandise from suppliers to increase the year-end inventory. The suppliers were the same ones who confirmed the phony receivables. The goods were shipped to the stores and billing was held back until after the auditors left the premises. Goods were also shipped from one store to another and double counted. Finally, management got hold of the auditors' inventory test count sheets and changed them to increase the numbers.</p> | <p>A comparison of year-end receiving documents to accounts payable. If goods were received prior to year-end, it is unlikely that this test would have been performed and the fraud would have gone undetected.</p> <p>Gross profit test would have resulted in too high a percentage.</p> <p>Number of days in inventory would have been high.</p> |
| <p>3. Timing differences: Using the accounting cutoff period to increase sales and/or reduce liabilities and expenses.</p> | <p>Eddie instructed his stores to hold the books open past the end of the year to increase sales. Liabilities were not recorded until the next period.</p> | <p>Sales cutoff test.</p> <p>Analytical procedures on end of year sales, by day.</p> |
| <p>4. Conceal liabilities and expenses: Not recording liabilities that exist at year end.</p> | <p>Eddie instructed his nephew to remove unpaid invoices from the files until the auditors left the premises.</p> | <p>Analytical procedures such as gross profit test and comparison of operating expenses from year to year might have caught the fraud.</p> <p>Comparison of accounts payable from year to year and number of days purchases in accounts payable might have shown unusually low accounts payable level relative to purchases.</p> |
| <p>5. Improper disclosures: Changing accounting principles or omitting other key disclosures.</p> | <p>Eddie changed the footnotes with respect to revenue and the auditors did not notice it.</p> | <p>A comparison of the footnotes from year to year would have caught this intentional error.</p> |

b. Misappropriation of assets (theft):

Misappropriation of assets involves the theft of an entity's assets where the effect of the theft causes the financial statements not to be presented in conformity with GAAP. Misappropriation of assets is usually accomplished by false or misleading records or documents, possibly created by circumventing controls.

Misappropriation of assets is accomplished in several ways, including:

- Embezzling receipts
- Stealing assets, and
- Causing the entity to pay for goods or services not received.

Note: An auditor is only concerned with a misappropriation of assets (theft or defalcation) that results in a *material financial statement misstatement*. Immaterial theft, for example, is not important to the auditor, per se. However, if an immaterial theft has occurred, the auditor should be concerned about the bigger picture and whether the occurrence of the theft suggests a deficiency in internal control.

Why do employees commit fraud for their own benefit?

Studies have profiled why employees commit fraud for their own benefit; that is, misappropriation of assets. An article by Joseph T. Wells, entitled *Why Employees Commit Fraud*, gives some insight into the lessons learned about employees who have committed fraud.

In the article, the author references a 20-year-old study by *Hollinger and Clark* in which 12,000 employees were profiled. The results of the study are startling:

- 90% of the employees committed "workplace deviance" such as workplace slowdowns, sick time abuses, and pilferage.
- 33% of the employees actually stole money or merchandise.
- There is a direct correlation between employee dissatisfaction and fraud: employees who commit fraud do so by justifying it as "wages in kind."

Example: A loyal bookkeeper was denied a \$100 monthly raise and stole for the next 20 years. The amount stolen was exactly \$100 per month.

Lessons from research disclose the following:

1. Employee and executive profiles are important to consider:

- a. Employees and executives who feel unfairly treated believe they are justified in committing fraud.
 - b. Employees and executives facing embarrassing financial difficulties are more likely to commit fraud.
2. Auditors should discuss with management the importance of improving internal controls even if the auditor does not rely on internal controls in performing the audit.
 3. Auditors should ask individual employees whether they suspect fraud. The studies reveal that auditors rarely ask the employees whether they believe any fraud is being committed.

Another study analyzed frauds based on three conditions of the fraud triangle: Incentive/pressure, opportunity, and rationalization.

The Study concluded that all three conditions drive an employee to commit fraud as noted in the following chart:

| | <u>% of frauds committed</u> |
|----------------------------------|----------------------------------|
| INCENTIVE/PRESSURE: | |
| Expensive lifestyle to maintain | 43% |
| Dissatisfaction with the company | 8% |
| Career disappointment | 10% |
| Layoff/redundancy | 4% |
| OPPORTUNITY: | |
| Insufficient internal control | 28% |
| External collaboration/collusion | 24% |
| Management over ride | 26% |
| Internal collaboration/collusion | 18% |
| Anonymity with the company | 16% |
| Foreign business customers | 2% |
| RATIONALIZATION: | |
| Lacked awareness of wrongdoing | 40% |
| Low temptation threshold | 36% |

| | |
|--|-----|
| Self-denial of consequences to company | 23% |
|--|-----|

Source: *Crisis Management- Economic Crime*, PWC.

From the Survey chart, it is obvious that the maintenance of an expensive lifestyle has been the greatest subcondition that drives incentive/pressure with it existing in 43% of the frauds committed.

Also, rationalization is a critical condition driving fraud with the primary subcondition of rationalization being a lack of awareness of wrongdoing (40% of frauds surveyed), and a low temptation threshold (36% of the cases). Notice that an insufficient internal control is a key driver in providing “opportunity” to commit fraud.

4. Small Business Fraud

Based on the report published by the Association of Certified Fraud Examiners entitled, *2016 Report to the Nation on Occupational Fraud and Abuse*, smaller privately held businesses are the greatest victims of occupational fraud. Specifically:

- 38% of all frauds occur in private companies, resulting in median losses of \$180,000
- 30% of frauds occur in companies with fewer than 100 employees.

From the Report, the frequency and median loss of cash frauds is broken down in the following table:

| <i>Asset Misappropriations - By Type</i> | | |
|--|-----------------------|--------------------|
| | <u>% of all cases</u> | <u>Median loss</u> |
| Involving cash receipts | | |
| Skimming | 12% | \$53,000 |
| Cash larceny | 8% | 90,000 |
| Involving fraudulent cash disbursements | | |
| <i>Billing schemes</i> | 22% | 100,000 |
| Check tampering | 11% | 158,000 |
| Expense reimbursements | 14% | 40,000 |
| Payroll schemes | 9% | 90,000 |
| Cash register disbursement schemes | 3% | 30,000 |
| Cash on hand misappropriations | 12% | 25,000 |
| Involving non-cash assets: | | |
| Non-cash misappropriations including inventory theft | 19% | 70,000 |

a. Fraudulent disbursements:¹¹

The greatest percentage of cash frauds involve some form of fraudulent disbursement.

Following is a table that summarizes the common types of fraudulent disbursements and examples of each.

¹¹ Excerpts from this segment were extracted from: *How to Prevent Small Business Fraud*, Association of Certified Fraud Examiners.

| Examples of fraudulent disbursements | |
|--|--|
| <u>Type of fraudulent disbursements</u> | <u>Example</u> |
| <u>Phony vendor</u> : Invoices are paid for fictitious goods or services, inflated invoices or goods or services related to the perpetrator. | A secretary sets up a phony vendor and submits faxed or emailed copies of invoices to the accounts payable department for payment. The fraud was discovered four years later when a manager identified a large variation in the budget. |
| <u>Phony employee</u> : Payment is made to a phony employee. | A controller who believes she should be earning more compensation adds a phony employee to the payroll records. Because she manages both the bank accounts and general ledger, she wrote a check to the phony employee and direct deposited the funds into her personal account. After three years, the fraud was detected during a surprise payroll audit. |
| <u>Expense reimbursements</u> : An employee submits a claim for reimbursement of fictitious or inflated business expenses. | John, a sales employee, submits on his expense report phony invoices for meals and entertainment. |
| <u>Check tampering</u> : A perpetrator forges, alters or steals a check. | The administrative assistant, who is also the company's bookkeeper, prepares and delivers checks to the CEO for payment on a weekly basis. The CEO quickly signs a manual the checks. The assistant prepares the checks with erasable ink and changes the payee on the checks after they are signed, and posts the checks to various general ledger accounts. When the checks are returned the assistant changed the payee back to the original payee. She is caught when, in haste, she altered checks related to the CEO's personal expenses. Total cost to the company was more than \$500,000. |
| <u>Register disbursement</u> : An employee makes false entries on a cash register to conceal the removal of cash. | A service station attendant learns that a cash sale can disappear altogether if he presses the "hold" button on the register for a few seconds. When a customer pays cash, the attendant pockets the cash and does not record the sale. The fraud was discovered when there was a significant difference between the fuel level and sales. Total cost to the company was \$132,000. |
| Source: <i>Small Business, Big Losses</i> , Joseph T. Wells, Journal of Accountancy, AICPA | |

b. Fraud involving cash receipts:

Fraud involving cash receipts can be segregated into two categories:

- Cash larceny
- Skimming

Cash larceny and skimming collectively represent 20% of all misappropriations of assets.¹²

Cash larceny:

Cash larceny occurs when an employee steals cash from a daily cash deposit.

Typical forms of cash larceny are summarized in the following table:

| Ways to conceal cash larceny | Internal controls to mitigate the concealment |
|---|--|
| <i>Deposit lapping:</i> An employee steals a deposit from one day and replaces it with a deposit from the next day. The second day’s deposit is replaced with the third day’s deposit, etc. The deposits are always one day behind. | Insist that deposits be made on a daily basis with an independent person verifying the dates and amounts of each deposit from the deposit slip and bank statement. |
| <i>Deposits in transit:</i> An employee steals a deposit and carries the missing deposit as a deposit in transit on the bank reconciliation. | Make sure there is a separation of duties between those that make the deposit and the one that reconciles the bank statement. |
| Source: <i>How to Prevent Small Business Fraud, Association of Certified Fraud Examiners.</i> | |

Skimming:

Skimming involves removing cash from an entity before the cash is recorded. It is commonly known as “off-the-books” fraud because there is no direct audit trail to detect the fraud. Typically, skimming involves an employee receiving a payment from a customer, pocketing that deposit and not recording the receipt of that payment.

Following is a chart that summarizes the common types of skimming schemes:

| Common Types of Skimming Schemes | |
|---|---|
| Skimming Scheme | Comments |
| <i>Skimming sales:</i> Theft of incoming sales. Easier to conceal than theft of receivables as payment | <i>On-site employees:</i> Most skimming occurs at the cash register by low-paid employees subject to a high-degree of temptation. |

¹² Cash larceny (8%) and skimming (12%)- 2016 Report to the Nation, ACFE.

| | |
|--|---|
| <p>for the sale is not expected while the receivable is.</p> | <p>Typically involves ringing in “no sale” or another non-cash transaction in the register.</p> <p><u>Remote salespeople</u>: Unsupervised off-site employees sell goods, retain the cash, and do not record the sale.</p> <p><u>Off-hours sales</u>: Employees conduct sales during off-hours without the knowledge of the owners.</p> <p><u>Mailroom theft</u>:¹³ Employees who open the mail steal incoming checks.</p> <p><u>Check-for-cash substitutions</u>: An employee receives unexpected revenue such as a rebate or refund. The employee sets aside the check. When an equal amount of currency is received, the employee takes the currency and replaces it with the check.</p> <p>Example: An unexpected rebate check is received for \$1,000. An employee steals \$1,000 of cash and replaces it with the rebate check.</p> |
| <p><u>Skimming receivables</u>: Theft of incoming receivable payments.</p> <p>Experienced fraudsters avoid skimming receivables in lieu of skimming sales.</p> <p>Receivable payments represent a payment from a customer expected to be received resulting in a much greater likelihood that the fraudster will get caught. Unpaid receivables show up on the past due listing.</p> | <p>The fraudster uses several concealment techniques:</p> <p><u>Forced account balances</u>: Employee posts the payments to the customer receivable accounts even though they have not been received. The difference is posted as a plug to cash.</p> <p><u>Fraudulent write offs</u>: Fraudster authorizes bad debt writeoff for an account skimmed.</p> <p><u>Debits to aging or fictitious accounts</u>: Improperly debiting the accounts of other customers (or fictitious customers) to account for the false credit to the skimmed customer account.</p> <p><u>Lapping</u>: Applying the payments of one account to another to conceal a skimming. Example: Check for Customer A is stolen. Check for Customer B is posted to account of Customer A to conceal theft, and so on.</p> <p><u>Stolen statements</u>: The fraudster intercepts the customer’s account statement and late notices or</p> |

¹³ According to the U.S. Post Office, 60 percent of customer payments are still done by mail.

| | |
|--|---|
| | changes the customer's address to ensure the customer does not receive a statement from the victim organization. <i>Destroying records:</i> The fraudster destroys all records that can implicate him/her in the skimming. |
| Source: <i>How to Prevent Small Business Fraud</i> , Association of Certified Fraud Examiners. | |

Note: With respect to sales skimming, one way to detect such skimming is through inventory shortages. An employee who skims a cash sale still must accommodate the customer who placed the sale. The employee will have to ship the customer goods for which sales have not been recorded, resulting in an inventory shortfall. Now the employee must conceal the inventory shortfall to cover up the sales skimming. Ways to conceal the inventory shortfall include writing off inventory as obsolete and adjusting the perpetual inventory to reflect the removal of the goods.

In reality, it is usually easier for a perpetrator to hide the inventory shortfall than the skimmed sales. If the sales skimming is relatively small, the inventory shortfall is not likely to be discovered and will wash through as normal shrinkage. Conversely, a large sales skimming could yield a significant inventory shortage and an unusually low gross profit percentage.

Which is the best type of fraud to commit if you are a fraudster?

Let's look at fraud from the perspective of the fraudster. In performing any fraud, the fraudster must take action on two fronts:

1. Conceal the fact that the crime has been committed, and
2. Conceal the identity of the fraudster.

For some frauds, concealing the fact that the crime has been committed may be easy, but concealing the identity of the fraudster may be difficult. Conversely, other types of fraud may be difficult to conceal but easy to hide the identity of the fraudster.

The following chart identifies types of fraud by level of concealment of both the fraud and fraudster.

| Comparison of Types of Frauds: Ease of Concealing Crime and Identity of Fraudster | | |
|--|--------------------------|--|
| | Ease of concealing crime | Ease of concealing identity of fraudster |
| <i>Fraud involving cash receipts:</i> | | |
| Cash larceny | Low | High |
| Skimming sales | High | High |
| Skimming receivables | Low | Low |
| <i>Fraud involving cash disbursement:</i> | | |

| | | |
|-----------------------|----------|------|
| Phony vendors | Moderate | Low |
| Phony payroll | Moderate | Low |
| Expense reimbursement | Moderate | Low |
| Check tampering | Moderate | Low |
| Register disbursement | Moderate | High |

From the chart, one can see that there is a wide difference between the risks of concealment and being caught based on types of frauds. In general, skimming of sales still continues to be the most attractive type of fraud to commit in that it is usually difficult to detect and, if detected, there is a lower probability that the perpetrator will get caught. Conversely, most fraud involving cash disbursements have the risk that, if the fraud is discovered, the perpetrator will be caught.

5. Evaluating an Entity's Fraud Environment

No organization is exempt from their exposure to fraud. Consequently, it is important that each entity evaluate its risk and exposure to fraud by considering the entity's culture and fraud risk factors.

Following is a chart that looks at variables (fraud risk factors) that might exist in high- and low-fraud risk environments.

| Environmental and Cultural Comparison of Organizations with High Fraud and Low Fraud Potential | | |
|---|---|---|
| <u>Variable</u> | <u>High-Fraud Potential</u> | <u>Low-Fraud Potential</u> |
| Management style | Autocratic | Participative |
| Management orientation | Low trust Power-driven | High trust Achievement-driven |
| Distribution of authority | Centralized, reserved by top management | Decentralized, dispersed to all levels, delegated |
| Planning | Centralized and short range | Decentralized and long range |
| Performance | Measured quantitatively and on a short-term basis | Measured both quantitatively and qualitatively and on a long-term basis |
| Business focus | Profit-focused | Customer-focused |
| Management strategy | Management by crisis | Management by objectives |
| Reporting | Reporting by routine | Reporting by exception |
| Policies and rules | Rigid and inflexible, strongly policed | Reasonable, fairly enforced |
| Primary management concern | Capital assets | Human, then capital and technological assets |
| Reward system | Punitive and penurious | Generous, reinforcing, and fairly administered |
| Feedback on performance | Critical and negative | Positive and stroking |

| | | |
|---------------------------|--|--|
| Interaction mode | Issues and personal differences are skirted or repressed | Issues and personal differences are confronted and addressed openly |
| Payoffs for good behavior | Mainly monetary | Recognition, promotion, added responsibility, choice assignments, plus money |
| Business ethics | Ambivalent, rides the tide | Clearly defined and regularly followed |
| Internal relationships | Highly competitive, hostile | Friendly, competitive, supportive |
| Values and beliefs | Economic, political, self-centered | Social, spiritual, group-centered |
| Success formula | Works harder | Works smarter |
| Human resources | Burnout, high turnover, grievances | Not enough promotional opportunities for all the talent Low turnover High job satisfaction |
| Company loyalty | Low | High |

| | | |
|--|---|--|
| Major financial concern | Cash flow shortage | Opportunities for new investment |
| Growth pattern | Sporadic | Consistent |
| Relationship with competitors | Hostile | Professional |
| Innovativeness | Copycat, reactive | Leader, proactive |
| CEO characteristics | Swinger, braggart, self-interested, driver, insensitive to people, feared, insecure, gambler, impulsive, tight-fisted, numbers- and things-oriented, profit-seeker, vain, bombastic, highly emotional, partial, pretend to be more than they are. | Professional, decisive, fast-paced, respected by peers, secure risk-taker, thoughtful, generous with personal time and money, people- products- and market-oriented, builder, helper, self-confident, composed, calm, deliberate, even disposition, fair, know who they are, what they are and where they are going. |
| Management structure, systems and controls | Bureaucratic, regimented, inflexible, and imposed controls | Collegial, systematic, open to change, self-controlled |

Source: *The CPA's Handbook of Fraud and Commercial Crime Prevention*, AICPA.

Signs that fraud may be present

If you are looking for the signs of fraud in a small business environment, consider whether any of the following factors are present:

| Signs of Potential Fraud | |
|---|---|
| Symptom in the Books | Possible Sign of Fraud |
| An increase in overall sales returns | Fraudster removed customer accounts receivable to conceal skimmed accounts receivable payment |
| Unusual bad debt write offs | Fraudster removed customer accounts receivable to conceal skimmed accounts receivable payment |
| Slow collections | Fraudster skimmed accounts receivable |
| Decline or unusually small increase in cash or credit sales | Sales are not being recorded |
| Inventory shortage | Sign of fictitious purchases, unrecorded sales, and employee theft |

Source: *Small Business Administration's Crime Prevention Series*

Not only should a company look at the technical signs of fraud noted in the previous table, companies should look at the psychological aspects of fraud and the symptoms that exist in changes in employee behavior. Examples of suspicious employee behavior include:

| Symptoms of Employee Fraud | |
|--|--|
| Behavior | Explanation |
| A suddenly enriched, extravagant lifestyle that is unsubstantiated by normal wages | Embezzlers need to demonstrate they can buy items with the money to improve their lifestyle. |
| Frequent requests for cash advances or delayed repayment of prior loans | Requests are indicators of expenses exceeding income, which may indicate an employee theft exists. |
| Telephone calls at work from creditors | Calls from a collection agency are typically the agency's last resort to collect, noting a severe personal cash flow problem. |
| Wage garnishment | Wage garnishment is typically a sign that embezzlement may already be in place. |
| Significant change in behavior, attitude, or performance | Embezzlement becomes a full-time, all-encompassing job the deeper the employee gets involved. Irritability, drastic mood swings and frequent mistakes all can be evidence of a larger problem. |
| Refusing to take time off | Embezzlers must hide their tracks and cannot give anyone else the chance to discover their fraud. |
| Gambling | Employees with a gambling, alcohol, or drug addiction find ways to finance their habit. |
| Source: Dana Turner, Security Education Systems, San Antonio, Texas | |

Employee background checks- do they work?

There are mixed opinions as to whether background checks on employees really work in predicting whether a prospective employee will be a fraudster. Fraud surveys indicate that most fraudsters are first-time offenders.

However, the background check that may be the most effective, is not one limited to contacting the previous employer since that employer would be reluctant to disclose a fraud anyway. Instead, a more expansive background check is most effective and costs about \$1,500 and should include:¹⁴

Do a database check to:

1. Verify address and previous employment
2. Look for civil claims related to:

¹⁴ Forensic Investigative Associates, NY, NY.

- a. Liens and judgments against the potential employee
 - b. Bankruptcy filings and litigation records
3. Hand search at local county courthouses in the counties where the person has held previous positions.

Note: Searching criminal records is useful but may not be effective for first-time offenders. In many states, a guilty plea for a first-time offender may be expunged from his or her record after one year.

In addition, all businesses should:

1. *Prosecute even the smallest of frauds to set the tone for the company and to stop the embezzler of the next employer, and*
2. Nurture an environment where employees can share information about potential frauds such as with an anonymous tips hotline.

Let's look at the following chart which summarizes some of the truths about employee dishonesty.

| 50 Honest Truths About Employee Dishonesty |
|---|
| The Employee and Your Company |
| Employers can create an atmosphere that fosters honesty, or dishonesty by the way they conduct business. |
| If you ask an employee to steal for you, don't be surprised when he steals from you. |
| Theft is the ultimate sign of employee disrespect toward you and your company. That disrespect is usually predictable, based on prior behavior. |
| Employees involved in theft have usually been involved in other prior misconduct at the company. |
| Employee theft is far more costly to your business than just the value of the goods stolen. |
| The employee who steals is more insidious than the outsider because that employee violated your trust. |
| No employee who steals is a "good employee" no matter how hard they otherwise work. |
| Psychology of Employee Theft |
| Need and opportunity are critical elements for theft to occur. |
| Need can be very superficial and at times difficult to understand. |
| An employee's ethical make up will temper the temptation to steal. |
| Virtually every employee who steals has rationalized his or her dishonesty. |
| Most employees would not steal if they couldn't rationalize it. |

Employees who steal believe that everyone steals and that most steal more than they do, no matter how much they have actually stolen.

A thief learns to lie before he learns to steal.

Tolerance of Theft

No theft, no matter how minor, should be tolerated or ignored.

Employees who know of unreported theft are as bad as the thief.

Theft is like a cancer- if left untreated it will continue to grow and spread.

In regard to your attitude towards dishonesty, most employees mistake kindness for weakness.

Most employees appreciate a second chance- to steal from you again.

Detection and Prevention

No one ever gets caught the first time.

The employee who is closest to the loss is usually the one who did it.

Be careful of the employee who discovered the loss.

When the person's explanation sounds suspicious, be suspicious.

Your so-called sixth sense is usually pretty accurate- it's actually a consolidation of your senses.

Employees who deny guilt, but are willing to perform restitution, are guilty.

When a number of employees suspect one person there's usually a pretty good reason.

Controls Over Theft

Virtually every theft situation could have been prevented by better management.

Nothing you own is immune from theft, and no business is theft proof.

Most businesses are loath to put controls over theft for a variety of reasons, which are invalid.

For some reason, companies are more eager to detect theft after the fact, than prevent it from happening, even though it is much cheaper to prevent it in the first place.

The best way to avoid employee theft is to not hire a thief.

The best way to not hire a thief is to investigate a potential employee's background.

If a person has stolen from a previous employer, why do you think he or she won't steal from you?

Constant and eclectic vigilance is required to prevent theft- there is no magic.

Isolating the responsibility is a critical theft prevention topic.

Never let the employee be his or her own check and balance.

Asset protection is in everyone's job description.

Effective security measures are not oppressive or burdensome.

Asset protection is an insurance. The cost should be weighed against the risk.

Crime and Punishment

There is no perfect resolution. Each case must be considered independently, the most just and intelligent disposition.

You cannot rely on the criminal justice system to protect your assets, investigate theft, or bring the culprit to justice.

If you want to understand the physics of a black hole, bring your employee fraud case to the typical big city court.

The employee who says he is sorry usually is- sorry to have been caught.

The employee who is remorseful today will be spiteful tomorrow.

If the only punishment the employee receives is termination, the proceeds of theft are his golden parachute.

If the dishonest employee offers to resign, accept it and avoid the urge to be vindictive.

Of the three “shuns” (termination, prosecution, restitution) restitution while the most difficult, does the victim the most good.

Source: *Honest Truths About Employee Dishonesty*, Steven Kirby, DFE Associate Editor, Fraud Section, PI Magazine.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. As noted by the FBI, what type of financial statement fraud involves a sales transaction in which a company issues a right of return or contingency letter to a customer as a condition of sale:
 - a. Accelerated revenue
 - b. Phony sales
 - c. Side letter agreements
 - d. Swap transactions
2. In the Crazy Eddie Rip-Off, how could the auditor have caught the fraudulent inventory valuations:
 - a. Compare accounts payable from year to year and number of days purchases in accounts payable
 - b. Compare the footnotes from year to year
 - c. Perform gross profit test and number of days in inventory
 - d. Perform sales cutoff test
3. Which type of fraud involves an employee stealing cash from a daily cash deposit:
 - a. Cash larceny
 - b. Phony vendor
 - c. Register disbursement
 - d. Skimming
4. What is a common concealment technique used by a fraudster who is skimming receivables:
 - a. Check-for-cash substitutions
 - b. Fraudulent writeoffs
 - c. Mailroom theft
 - d. Off-hours sales
5. Which organization has the highest fraud potential:
 - a. A customer-focused organization
 - b. An organization that has decentralized authority, dispersed to all levels
 - c. An organization that measures performance quantitatively, on a short-term basis
 - d. An organization with a collegial, systematic, self-controlled management structure

SUGGESTED SOLUTIONS

1. As noted by the FBI, what type of financial statement fraud involves a sales transaction in which a company issues a right of return or contingency letter to a customer as a condition of sale:
 - a. Incorrect. Accelerated revenue is the recording of sales in the current period even though they relate to future periods. In some cases, the scheme is consummated by backdating sales contracts or other agreements.
 - b. Incorrect. Using phony sales involves creating invoices for products that were never sold, often made to foreign companies so that auditors have difficulty verifying the legitimacy of the sale.
 - c. **Correct. Side letter agreements involve a sales transaction in which a company issues a right of return or contingency letter to a customer as a condition of sale. The letters usually give the customer the right to return any products it cannot sell.**
 - d. Incorrect. Swap transactions involve two companies exchanging their products and payments for the sole purpose of increasing each other's revenues.
2. In the Crazy Eddie Rip-Off, how could the auditor have caught the fraudulent inventory valuations:
 - a. Incorrect. A comparison of accounts payable from year to year and determined number of days purchases in accounts payable would have caught the concealment of liabilities and expenses, but not the fraudulent inventory valuations.
 - b. Incorrect. If the auditor had compared the footnotes from year to year, Crazy Eddie's intentional changes to the disclosure footnotes would have been detected, but not the fraudulent inventory valuations.
 - c. **Correct. If the auditor had performed a gross profit test, it would have resulted in too high a percentage. In addition, the number of days in inventory would have been high. Both tests might have uncovered the fraudulent inventory valuations.**
 - d. Incorrect. The sales cutoff test might have detected timing differences in recording sales, but was unlikely to uncover the fraudulent inventory valuations.
3. Which type of fraud involves an employee stealing cash from a daily cash deposit:
 - a. **Correct. Stealing from a daily cash deposit is referred to as cash larceny.**
 - b. Incorrect. The creation of phony vendors is a type of fraudulent disbursement. In this type of fraud, invoices are paid for fictitious goods or services, inflated invoices or goods or services related to the perpetrator.
 - c. Incorrect. Register disbursements is a type of fraudulent disbursement that has nothing to do with stealing daily cash deposits. In this type of fraud, an employee makes false entries on a cash register to conceal the removal of cash.
 - d. Incorrect. Skimming is one of the two categories of fraud involving cash receipts, but does not involve stealing cash from the daily cash deposit (cash larceny). Unlike cash larceny, skimming involves removing cash from an entity before the cash is recorded. It is commonly known as "off-the-books" fraud because there is no direct audit trail to detect the fraud.
4. What is a common concealment technique used by a fraudster who is skimming receivables:

- a. Incorrect. Substituting checks for cash might be an effective technique when skimming sales, but not skimming receivables. Using this technique, the employee receives unexpected revenue such as a rebate or refund, which is set aside. When an equal amount of currency is received, the employee takes the currency and replaces it with the check.
 - b. **Correct. Fraudulent writeoffs is an effective concealment technique with fraud involving receivables. The fraudster skims receivable collections and then authorizes a bad debt writeoff for an account skimmed.**
 - c. Incorrect. A fraudster who is skimming sales might open the mail in the mailroom and steal incoming checks. However, this technique does not work well for skimming receivables because ultimately the customer who sent in the check will question why he or she has not been credited for the payment sent.
 - d. Incorrect. A fraudster who is skimming sales might conduct sales during off-hours without the knowledge of the owners. This approach does not involve skimming receivables.
5. Which organization has the highest fraud potential:
- a. Incorrect. In general, a customer-focused organization has low-fraud potential, whereas a profit-focused organization has high-fraud potential.
 - b. Incorrect. An organization that has decentralized authority, dispersed to all levels, has low-fraud potential, whereas an organization that has centralized authority, reserved by top management, has high-fraud potential.
 - c. **Correct. An organization that measures performance quantitatively and on a short-term basis has higher fraud potential. On the other hand, an organization that measures performance both quantitatively and qualitatively and on a long-term basis has lower fraud potential.**
 - d. Incorrect. An organization with a collegial, systematic, self-controlled management structure that is open to change has low-fraud potential, not high-fraud potential.

6. Time Theft

There are indirect ways in which employees can steal from their employer. One such way is time theft. Companies are coming to the realization that time theft can be just as severe as embezzlement and no one goes to jail.

One study¹⁵ concludes that the average employee steals approximately 54 minutes per day (4.5 hours per week), from his or her employer, for a total of six full work weeks per year- more than 10 percent of total payroll.

- a. Examples of time theft forms include:
 - Late arrival or early departure
 - Requesting paid sick days for inappropriate reasons
 - Excessive socializing and personal telephone calls
 - Using company time and facilities to operate another business
 - Taking long lunch breaks
 - Slowing down the workload
 - Handling personal business during work hours.
- b. Time theft applies to all business whether white or blue collar based.
- c. Permanent employees steal more time than temporary employees.
- d. ***The greater the seniority, the greater the chance they will steal time from their employer.***
- e. Office personnel steal more time than manufacturing personnel.
- f. Employees under age 30 steal more time than employees age 30 or older.

The following chart quantifies the impact of time theft on a typical business:

Assumptions used in the chart:

- 20 minutes per day time theft as follows: Arrival at work 5 minutes late, leave 5 minutes early (10 minutes lost per day) 5 minutes early for lunch, and 5 minutes late for lunch (10 minutes lost per day)
- 250 working days per year

¹⁵ Acroprint- *Is Time Theft Robbing You Blind?*

| Computation of Time Theft | | | |
|----------------------------------|------------------------------|--------------------|------------|
| <u>Hourly Rate</u> | Hourly including fringes 30% | <u>Lost profit</u> | |
| | | <u># employees</u> | |
| | | 10 | 25 |
| \$7.25 | \$9.50 | \$(7,916) | \$(19,790) |
| 9.00 | 12.00 | (9,996) | (24,990) |
| 11.00 | 14.30 | (11,912) | (29,780) |
| 15.00 | 19.50 | (16,245) | (40,610) |
| 18.00 | 23.40 | (19,500) | (48,750) |

As one can see from the chart, 20 minutes of wasted time per employee can result in thousands of dollars of lost profit for an organization.

How to reduce time theft?

Employee time and attendance systems can be used to significantly reduce time theft by eliminating the ability to come in early and leave early, as well as taking additional time at lunch.

Time and attendance systems can be used to reward or penalize employees during the employment reviews.

7. Employee Background Checks and Credit Reports

Should an employer do a background check (including an employee's credit report) in deciding whether to hire that employee?

More companies are performing detailed background checks, including obtaining a credit report, on prospective hires and using that information as part of the decision to hire. Typically, such checks are useful in uncovering information on an employee that might not otherwise be extracted toward the performance of other traditional efforts. According to one report, 40 percent of employers now run credit reports.¹⁶

It is estimated that 40 percent of resumes, contain false or inaccurate information.¹⁷

So, why perform a detailed background check including a credit report?

There are several reasons for performing a detailed background check, including obtaining a credit report:

- a. It could protect the employer from a future negligence claim based on the actions of that employee while employed.

¹⁶ U. S. News & World Report

¹⁷ InfoLink Screening Services, Inc.

- b. It may uncover a criminal record.
- c. It may help evaluate the employee's ability to manage financial affairs. "If he or she cannot manage his or her own financial affairs, why could he or she do so for our organization?"
- d. Hiring the right employees may avoid high turnover costs which can run as high as \$10,000 per employee position.¹⁸

Not only is the background check useful in assessing the way in which an employee manages his or her financial affairs, but also may be necessary to protect the company from a future liability claim due to the actions of that employee. Not only can an employee be negligent during his or her employment, but there is also risk that an employee has an undisclosed criminal record. One study noted that employers lost 79 percent of all negligent hiring suits with an average jury plaintiff award that exceeds \$1.6 million. In some cases, damages are assessed against an employer because an employer fails to perform a background check on an employee prior to hiring.

If an employer does obtain a credit report, there are certain requirements that must be met under the Fair Credit Reporting Act (FCRA) including disclosure to the employee of his or her rights under that Act.

8. The Auditor's Role in Dealing with Fraud

a. General:

In reviewing the incidents of fraudulent financial reporting that have been publicized, there are some facts that the auditor should consider. Among these is the fact that even the strongest of internal control systems can be circumvented by collusion or management override. Moreover, a weak internal control system tempts not only dishonest employees but also those who are on the fringe; the person who does not plan to steal but does so when tempted and desperate.

Test the one-dollar bill rule to see if someone is honest:

Drop a dollar bill and see if the person walking directly behind you gives it back.
Do the same for \$5, \$10, \$50, and finally \$100, if you dare.

What does this test tell you about human nature?

In this hypothetical situation, some individuals would give the money back and some, unfortunately, would not. In most instances, the person who keeps the bill would otherwise be an honest person and certainly not one scheming to steal from another. In fact, the person did not reach into your pocket or grab your wallet or pocketbook. But when the temptation was presented (e.g., a bill lying on the ground), he or she committed the theft. A parallel exists with an employee who commits fraud (theft). Most employees who steal from their employer do not scheme to

¹⁸ William M. Mercer, Inc.

commit the fraud. Similarly, management generally does not plan to commit fraudulent financial reporting. But when the temptation presents itself through a weak internal control system coupled with other factors (such as financial pressures), the employee that is on the fringe might steal and management may possibly commit financial statement fraud.

The moral of the story is for companies to strengthen their internal controls and take the temptation away from the weak and weary!

b. The auditor's role in dealing with fraud- AU-C 240 (formerly SAS No. 99) requirements:

SAS No. 122, AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99), provides requirements for auditors to consider fraud in a financial statement audit. It applies to audits of both public and non-public entities.

The primary actions auditors must take in complying with AU-C 240 (formerly SAS No. 99) are as follows:

An auditor must:

1. Exercise *professional skepticism* during the audit including:
 - Having a *questioning mind* and performing a critical assessment of all audit evidence received
 - Possessing a “*show me*” mindset that recognizes the distinct possibility that a material misstatement due to fraud could be present
 - Evaluating information received by management *without any bias to past experience* with the entity and regardless of the auditor’s belief about management’s honesty and integrity
 - Conducting *ongoing questioning* of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred, and
 - Probing evidence more thoroughly and critically.

Note: Professional skepticism does not assume that management or employees are guilty or innocent of committing fraud. Instead, it is based on a *degree of neutrality*.
2. Conduct a *brainstorming session* with audit engagement personnel to discuss the risks of material misstatement due to fraud and set the tone of the audit.
3. Make greater inquiries of management and other personnel within the entity about the risks of fraud.
 - Inquiries include those of management, internal auditors, audit committee chairman, and others (such as sales and marketing, and receiving personnel).
4. Perform analytical procedures including *specific procedures on revenue*.

Examples of analytical procedures related to revenue follow:

- Compare recorded sales volume with production capacity - an excess of sales volume over production capacity may indicate the recording of fictitious sales.
 - Perform trend analysis of revenues by month and sales returns by month during and shortly after the reporting period. Variations may indicate the existence of undisclosed side agreements with customers to return goods that would preclude revenue recognition.
 - Compare revenue to variable expenses (cost of sales, commissions, etc.) for significant fluctuations.
 - Review bad debt writeoffs in relation to sales.
5. *Consider an expanded list of fraud risk factors*: AU-C 240 offers a list of fraud risk factors that need to be considered in planning the audit. The list is not included in this section but is part of the appendix to AU-C 240.
6. Perform three additional procedures to deal with the risk of management override of internal controls:
- a. *Examine journal entries* and other adjustments for evidence of possible material misstatement due to fraud.
 - b. Review *accounting estimates for biases* that could result in material misstatement due to fraud.
 - The auditor also should perform a *retrospective review of significant accounting estimates* reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.
 - c. Evaluate the business rationale for *significant unusual transactions*.
7. Include fraud language in the management representation letter.

The following language must be included in the management representation letter for an audit per SAS No. 122, AU-C Section 580: *Written Representations*:

We acknowledge our responsibility for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

We acknowledge our responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud.

We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

We have no knowledge of any[or disclosed to you all information] that we are aware of in relation to fraud or suspected fraud that affects the entity and involves:

- *Management;*
- *Employees who have significant roles in internal control; or*
- *Others where the fraud could have a material effect on the financial statements.*

We have no knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

Has the fraud standard found in SAS No. 99 (now AU-C 240) worked in reducing fraud?

Unequivocally, no. One of the greatest disappointments and wasted efforts of the Auditing Standards Board (ASB) has been the requirement for auditors of non-public entities to spend additional time and effort complying with the requirements of SAS No. 99 (now AU-C 240).

Consider a few facts:

1. SAS No. 99 (now AU-C 240) was effective for audits of financial statements for periods beginning on or after December 15, 2002.
2. According to the *Reports to the Nation*, published by the Association of Certified Fraud Examiners (ACFE), the percentage of frauds discovered by external audits was as follows for each of the ACFE's bi-annual reports:

| Frauds Detected by External Audit as Compared with By Accident | | | |
|---|--------------------------------|---|--------------------|
| <u>Report to the Nation</u> | <u>Before/after SAS No. 99</u> | % of frauds initially detected by the external <u>audit</u> | <u>By accident</u> |
| 1996 study | Before SAS No. 99 | NA | NA |
| 2002 study | Before SAS No. 99 | 11% | 19% |

| | | | |
|-------------------|-------------------------|-----------|-----------|
| 2004 study | After SAS No. 99 | 11% | 21% |
| 2006 study | After SAS No. 99 | 12% | 21% |
| 2008 study | After SAS No. 99 | 9% | 25% |
| 2010 study | After SAS No. 99 | 4% | 9% |
| 2012 study | After SAS No. 99 | 3% | 7% |
| 2014 study | After SAS No. 99 | 3% | 7% |
| 2016 study | After SAS No. 99 | 4% | 6% |

Source: *Report to the Nation*, Association of Certified Fraud Examiners.

3. By some estimates, auditors have had to expend 5 to 10 percent additional time to comply with SAS No. 99's (now AU-C 240's) requirements. What is most troubling is that the additional effort has resulted in little benefit in uncovering material misstatements in financial statements.

In looking at the chart consider the following conclusions:

- a. There has been no increase in the percentage of frauds detected due to the external audit. In 2002, the percentage of frauds detected due to the external audit was approximately 11 percent prior to the implementation of SAS No. 99. Since that time, in the post-SAS No. 99 environment, the percentage has actually declined to a low of 3 to 4 percent in 2012, 2014 and 2016.
- b. More than double the percentage of frauds were detected "by accident" as compared with through the external audit. In fact, the 2008 study revealed that 25 percent of frauds were detected "by accident" as compared with 9 percent detected through the external audit. A similar relationship applies to the other report years where, in each year, the percentage detected by the external audit is lower than that percentage detected by accident.

What this suggests is that the overall goal of SAS No. 99, which was to provide the auditor with the tools to detect material misstatements to the financial statements due to fraud, has failed. Instead, it has resulted in wasted auditor time, some of which cannot be passed on to the client in terms of higher audit fees. After all, few non-public clients see any benefit in an auditor performing an extra 5 to 10 percent audit time to perform certain procedures under SAS No. 99, when those procedures do not translate into uncovering fraud. Will that client agree to pay an audit fee that is 5 to 10 percent higher when there is no measurable benefit?

Why did the Auditing Standards Board issue the original SAS No. 99 in the first place?

A primary reason for the ASB's issuance of SAS No. 99 was political. Previously, the ASB had issued SAS No. 82 to address the auditor's responsibility for detecting fraud. SAS No. 82, which was issued in 1997, was complex, and not very functional. SAS No. 99 was issued to replace SAS No. 82, and to provide clearer and more comprehensive requirements.

Another point relates to the timing at which SAS No. 99 was issued and its effective date of 2002 year-end audits. Prior to 2003, the ASB was responsible for issuing auditing standards that pertained to all audits; public and nonpublic companies, alike.

In 2002 and 2003, events changed.

During 2002, in light of the Enron and WorldCom frauds, among others, the ASB was under significant criticism by Congress and pressure to clean up auditing standards. In particular, Congress criticized the accounting profession (in particular the national CPA firms) for performing non-attest services for audit clients, and for the profession's overall failure to detect the Enron and WorldCom frauds, among others. The issuance of SAS No. 99 was one of several efforts by the ASB to demonstrate that the auditing profession could continue to self-regulate and was serious about fraud.

Ultimately, Congress took the responsibility for issuing auditing standards for public companies away from the ASB, giving that responsibility to the then newly created Public Company Accounting Oversight Board (PCAOB), effective in 2003. The result at that time was that the ASB had issued a voluminous SAS No. 99 for all auditors in hope of appeasing the SEC community. When the responsibility for issuing auditing standards for SEC companies was taken away from the ASB in 2003, only auditors of nonpublic companies were left having to deal with the aftermath of SAS No. 99. It is fair to say that ten years later, SAS No. 99 (now AU-C 240) has been a flop, and the burden of having to comply with this standard has fallen on the shoulders of auditors of nonpublic companies, who continue to have difficulty having to pass on the cost of implementing SAS No. 99 onto smaller nonpublic companies, with little benefit in terms of detecting more fraud.

The issuance of SAS No. 99 is nothing more than an example of a long string of poorly drafted, arduous auditing standards issued by the ASB.

The reality is that the percentage of material frauds affecting non-public companies is de minimis according to several major malpractice carriers. In general, financial statement fraud was not a major problem with nonpublic companies before the issuance of SAS No. 99, and continues not to be a problem.

c. Look for the warning signs of fraud before and during the audit:

One of the key elements emphasized in AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit* (formerly SAS No. 99), is for an auditor to have heightened professional skepticism in conducting his or her audit. The AICPA's *Audit Risk Alert* identifies a list of "circumstances and observations" that should catch the attention of the auditor.

1. *A company that has a culture of arrogance:* The "tone at the top" sets a company's culture and values. A culture of arrogance provides an atmosphere in which bad behavior can flourish. Management that engages in fraudulent financial reporting often demonstrates:
 - A high degree of arrogance, pride, greed, and hubris
 - A reputation for being extremely aggressive in taking excessively high risks, and living "on the edge"
2. *Accounting policies that appear to be too aggressive or rely heavily on management's judgment:* The method by which accounting principles are selected affects the manner in which the financial statements are presented to third-party users and the accuracy, transparency, and understandability of those statements. Management has the ability and temptation to manipulate financial reporting in instances where GAAP permits different alternatives of principles that can be used to account for a transaction, where there is a high degree of subjectivity in using estimates or judgment, or if GAAP is unclear in an existing or evolving area. By abusing the selection and use of accounting principles, management can alter earnings and manipulate various accounts and transactions to report distorted financial statements and conceal certain important information.
3. *An ineffective audit committee and board governance:* An ineffective audit committee and board of directors result in a lack of monitoring of the financial reporting process.
 - a. An ineffective audit committee is one that:
 - Lacks independence
 - Fails to meet regularly
 - Lacks members who have financial expertise
 - Does not interface directly with the internal or external auditors
 - Does not monitor important company programs

Note: The Sarbanes-Oxley Act of 2002 increased the responsibilities of audit committees and limits the conflicts of interest that have existed on such boards for years. Although the requirements of Sarbanes-Oxley apply only to public companies and their auditors, the restrictions that it places on audit committees can be followed by non-public entities.

4. *An overly centralized control over the financial reporting process:* Internal control is compromised when one member of senior management or a small group of management retains control over the financial reporting process.
 - a. The opportunity and likelihood for fraudulent financial reporting exists in situations in which management controls the reporting process and takes steps to restrict access to important information required by third party users and auditors.
5. *Ratios and benchmarks that significantly vary from industry averages:* A company that has ratios and benchmarks that differ from other companies within the industry may be a sign of financial statement fraud. Benchmarking research and analysis may be useful in pinpointing possible business problems including signs that the company could be in financial difficulty or that there is a manipulating of the financial reporting process.
6. *A cash flow from operations that has little relationship to GAAP earnings:* A sign of possible financial statement fraud is where reported GAAP earnings do not correspond with the actual cash flows of the company.
 - a. If management is manipulating earnings, there may be a sign of such actions in a disparity between cash from operations and GAAP earnings.
 - b. An entity with negative cash flows may be a sign of a going concern problem.
7. *Compensation plans that reward management for achieving aggressive financial goals or are geared toward enriching executives rather than generating profits:*
 - a. In situations in which management's compensation is linked to certain operating or financial targets, management may put pressure on employees to meet overly aggressive goals.
 - b. A high-pressure environment can provide the need to establish overly aggressive practices and the motivation to operate beyond acceptable practices.
 - c. Auditors should be aware of the power of greed in motivating management and other employees to take actions they might not otherwise take.
8. *The existence of significant insider trading:* When senior management has a sizeable sell-off of their company stock, such an action may be a sign that they believe the stock value is overstated and that the financial reporting does not purport the real economic value of the company.
9. *There is confusion and difficulty in understanding how a company actually makes its money:*

A sign of fraud may be that an entity is involved in many businesses and complex transactions coupled with a difficulty by third-parties in understanding how a company actually makes its money and generates cash.

10. Forecasts and predictions by management that are inconsistent with industry trends:
Management may develop accounting estimates, make business decisions, or make predictions and forecasts that contradict with actual industry trends and other evidence about what other companies within the industry are doing or forecasting.
11. Unchecked acquisition growth: Management may acquire businesses for the sake of accumulating assets rather than for the good of the company. Overly aggressive growth by acquisitions can create havoc in a company in ways such as:
 - Creating difficulties in merging different operations and internal control processes
 - Stressing the abilities of the existing internal control system to accommodate the additional operations and transactions, and
 - Limiting the entity's liquidity and access to additional capital.
12. Turnover of key management personnel: The resignation or termination of key personnel may be a sign that there are future troubles at the entity and that they knew something about the company's financial future that outsiders are unaware of.
13. Declining relationships and credibility with customers, creditors, and other third parties: The deterioration of company third-party relationships may be a sign of financial difficulties or inappropriate activities by the company.
14. Continued periods in which the company experiences success: Entities that have had a prolonged period of financial success may have difficulty envisioning a financial downturn. Management may not have a clear perspective about the condition of the economy, company and industry in which the company operates. As a result, management may inappropriately make decisions without taking into account the typical peaks and troughs in the business cycle.
15. Management that does not listen to the comments of key employees: Key management may be so focused on achieving a self-serving purpose, such as an increase in stock price, that it may fail to listen to the suggestions of employees and notice the warning signs that the company is in trouble.
16. Receivables that are growing faster than sales: If sales are declining, management may attempt to inflate receivables to improve its financial position. Also, growing receivable balances relative to sales may indicate that the quality of receivables has deteriorated and that sales are being made to higher-risk customers thereby increasing the risk that receivables may not be collectible.
17. Unusual changes in gross profit: Changes in gross profit may suggest a mismatch between sales and cost of sales including cutoff problems or over and under-stated sales.
18. Sizeable decline in stock price: A decline in stock price may be indicative that the investment community knows something about the financial deterioration of the company.

19. Failure to satisfy past-due obligations: The inability to pay past-due obligations is a sure sign of liquidity problems.
20. Inability to obtain financing: A sure sign of a deteriorating financial position is when lenders are reluctant to provide financing to a client or the company is required to pay a higher interest rate to reflect the lender's perception of higher risk from lending to the company.
21. Evidence that management has previously committed dishonest or illegal acts: If a client has been dishonest in the past, he or she is more inclined to conduct similar acts in the future.
22. Net income that is growing disproportionate to revenue growth: A red flag exists when net income grows at a faster or slower pace than revenue. In doing so, there is the possibility that some aspect of the income statement is distorted.
23. The company engages in transactions that lack economic substance: A transaction that lacks economic substance may suggest that fraud is involved, particularly where there are complex, one-time transactions including those that occur near year end.
24. The company is obsessed with meeting earnings targets: Management that is under pressure to meet earnings targets is more likely to commit fraud.
25. A large company that continues to have a small business mentality: A large company's management may still retain control of the internal control environment even as the company continues to grow. The centralized control of operations creates a greater risk that management might override internal controls.

d. Remember that analytical procedures are the key:

The auditor is only concerned about material fraud, that is, fraud that results in a material misstatement to the financial statements. Although finding fraud may be synonymous with finding a needle in a haystack, numerous cases against auditors points to one conclusion-- fraud was right under the auditor's nose and he or she didn't even see it. The reason why it was not discovered was because the auditor forgot to perform certain analytical procedures that would have pointed to an obvious problem.

Also, if there is litigation against the auditor, the plaintiff will no doubt point to SAS No. 122, AU-C 520, *Analytical Procedures* (formerly SAS No. 56) and the fact that the auditor did not perform adequate analytical procedures that might have uncovered fraud.

e. Auditors need to corroborate evidence:

Weak audit procedures increase the risk that deficiencies in internal control and poor accounting practices will not be noticed. Examples of audit procedures that enhance the risk that fraud might not be detected include:

- Accepting verbal or written representations by company management and personnel without obtaining independent corroborating evidence of such representations.
- Accepting confirmations sent directly to the company being audited instead of the auditor.
- Failure to confirm unusual transactions with third parties.

9. Specific Fraud Issues

The types of assets and transactions subject to fraud vary depending on whether the fraud involves fraudulent financial reporting (cooking the books) or misappropriation of assets (theft).

It also depends on whether the company is large or small, and closely held versus publicly held.

The following table compares the two types of frauds:

| Description | Fraudulent Financial Reporting | Misappropriation of Assets (Theft) |
|--|---|--|
| Types of assets or transactions | Inventories, receivables and revenue | Cash –81% ¹⁹ Inventories and other assets –19% |
| Typical perpetrator | Management | All levels of employees and management |
| Primary reason for actions <ul style="list-style-type: none"> • Incentive/pressure • Opportunity • Rationalization/attitude | Incentive/pressure | Opportunity and rationalization/attitude |
| Size of transaction | Usually material to the financial statements | Usually immaterial to the financial statements |
| Type of entity more likely to be victimized | Larger entity with sophisticated financial management | Closely held businesses with poor internal controls |

a. Inventory fraud issues:

Inventory typically represents a major asset of many companies and one that can be easily manipulated. For example, a company with high sales can overstate inventory by a sizeable amount and the difference may not appear as a material difference in the gross profit percentage.

Consider the following example:

Facts:

¹⁹ 2016 Report to the Nation, Occupational Fraud and Abuse (the Report), Association of Certified Fraud Examiners.

| | | |
|-----------------------|--------------|-------|
| Sales | \$50,000,000 | |
| Gross profit | 10,000,000 | = 20% |
| Net loss before taxes | \$(100,000) | |

Assume that management fraudulently increases ending inventory by \$500,000, the impact on the gross profit would be as follows:

| | | |
|--------------------------------|---------------|-------------------|
| | <u>Actual</u> | <u>Fraudulent</u> |
| Gross profit | 20% | 21% |
| Net income (loss) before taxes | \$(100,000) | \$400,000 |

If management can devise a method to conceal the \$500,000 inventory overstatement from the auditor, the one percent increase in gross profit would most likely be accepted by the auditors as a reasonable change. Yet, the change converts a \$(100,000) loss to a \$400,000 profit, making its effect dramatic in the eyes of the financial statement users. This example represents a challenge to auditors whereby a standard analytical procedure, such as a gross profit percentage test, does not uncover a material fraud.

Unfortunately, in many cases of inventory fraud, client personnel at various levels knowingly participate and assist in the scheme. The following are examples of inventory frauds that have occurred in recent years.

Types of inventory fraud:

1. Nonexistent items recorded as inventory:

- Empty boxes or "hollow squares" in stacked goods
 - Mislabeled boxes containing scrap, obsolete items or lower value materials
 - Consigned inventory, inventory that is rented, or traded-in items for which credits have not been issued, and
 - Diluted inventory so that it is less valuable (e.g., adding water to liquid substances).
2. Management increased or otherwise altered the inventory counts for those items the auditor did not test count or client obtained auditor's test counts and changed counts on items that were not tested.
 3. Management programmed the computer to produce fraudulent physical quantity tabulations or priced inventory listings.
 4. Management manipulated the inventory counts/compilations for locations not visited by the auditor.
 5. There was double-counting inventory in transit between locations.
 6. Inventory was physically moved and counted in two locations.

7. Inventory included merchandise recorded as sold, but not yet shipped to a customer ("bill-and-hold sales").
8. Management arranged for false confirmations of inventory held by others.
9. There was a mismatch between inventory being recorded without the corresponding payables.
10. The stage of completion of work-in-process was overstated.
11. Management reconciling physical inventory amounts to falsified amounts in the general ledger.
12. Management manipulated the "roll forward" of an inventory taken before the financial statement date.
13. There were inadequate reserves for slow-moving and obsolete inventory.

Audit considerations- inventory fraud:

Even though there are numerous ways inventory frauds can be orchestrated, a well-planned audit can mitigate many inventory fraud schemes.

1. At the planning stage:

- Use analytical procedures such as:
 - Comparison of high to low inventory value listings or year-to-year quantities, and
 - Identify material items that represent high dollar value as a percentage of estimated inventory.
- Understand the client's business, its products, computer processing applications and relevant controls and cutoff procedures before physical counts are taken.
- Multi-location observations: Observe inventories simultaneously, if possible, to ensure that goods are not double counted.
- Interim date observations: When a client plans an observation at a date other than year end, the auditor must consider the effectiveness of internal controls, cutoff procedures and other issues that may impact the auditor's ability to audit the "roll forward" of the inventory value to year end.

2. During the physical count:

- Test some counts at all locations to ensure items are not double counted.
- Apply analytical procedures to the final priced-out inventory.
- Make test counts in areas in which the auditor has not historically focused.
- Record counts of some items that the auditor did not actually count for comparison with final inventory listing.
- Open containers checking for "hollow squares" or empty containers.

- For WIP inventories, consider the reasonableness of the stage of completion.
- When incorrect counts are observed, the auditor needs to consider whether to increase test counts or expand other procedures.
- Scan inventory tags or count sheets for unusual or unreasonable quantities and descriptions.
- Monitor the client's control procedures over physical count tags or sheets.

3. Inventory at multiple locations:

- Take the physical inventory at all significant locations at the same time.
- When the physical count at a significant location will not be observed, notify management that observations will be performed at some locations without advance notice, to discourage management's manipulation of the inventory.

Note: Where multiple locations, each geographically apart, make it difficult for a small firm to audit all of them, the firm may consider hiring a local CPA firm at each remote location to perform the inventory observation.

4. Inventories held for or by others:

- Review client procedures to segregate consigned goods from the inventory.
- Outside warehouses: If material, the auditor should consider observing the goods held in an outside warehouse or, obtain written confirmation from the warehouse in accordance with SAS No. 122, AU-C Section 501, *Audit Evidence- Specific Considerations for Selected Items* (formerly AU 331).²⁰

5. Use of specialists in inventory valuation:

- In certain situations, an auditor may not possess the expertise with respect to properly assess the client's inventories. In these cases, an auditor may need the work of a specialist and should follow AU-C 620, *Using the Work of an Auditor's Specialist* (formerly SAS No. 73)²¹ guidance.

6. Post-observation matters:

- The extent of audit procedures required normally increases when the inventory observation is performed at a date other than the balance sheet date.

An auditor should assess audit risk and key controls to ensure that the inventory can be properly valued at the balance sheet date.

b. Revenue fraud issues:

²⁰ Effective December 31, 2012, AU-C 501, *Audit Evidence- Specific Considerations for Selected Items*, replaced AU 331.

²¹ Effective December 31, 2012, AU-C 620, *Using the Work of an Auditor's Specialist*, replaces SAS No. 73.

In the recent years, there have been several high-profile cases involving improper revenue recognition that should wake up auditors to the risks associated with this area. Of particular concern is the accounting for high-risk transactions such as those that are unusual and complex in nature and significant year-end transactions. Even if transactions are not unusual and complex in nature, auditors should consider the risk that revenues may be misstated whether intentional or unintentional.

The general rule for revenue recognition is found in FASB Concept Statement No. 6, *Elements of Financial Statements*. Statement 6 defines revenues as “inflows or other enhancements of assets of an entity or settlements of its liabilities from delivering or producing goods, rendering services....”

SAB No. 101, *Revenue Recognition in Financial Statements*, offers four criteria that need to be met in order to recognize revenue:²²

1. There is persuasive evidence that an arrangement exists.
2. A delivery of goods has occurred or services have been rendered.
3. The seller’s price to the buyer is fixed and determinable.
4. Collectability of the sale or service is reasonably assured.

Although the above four criteria appear easy to understand, their application can be difficult. Many sales transactions may satisfy some, but not all, of the four criteria. Others, in form, may appear to satisfy the criteria, but in substance, do not.

Types of revenue fraud:

The following are examples of revenue-related areas that pose a high risk:

- A dramatic increase in sales, receivables and gross profit margins totally inconsistent with past experience or industry averages
- Certain sales of merchandise that are billed to customers prior to delivery and held by the seller (bill-and-hold transactions)
- Significant transactions with one or a few transactions near year end:
 - Unusually large increases in year-end sales to a single or a few customers, particularly to new customers
 - Significant returns from a single or a few customers after year end
- Sales in which the customer has the right to return the goods

²² In 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which supersedes all revenue recognition standards and is effective for 2018 (2019 for nonpublic entities).

- Partial shipments in which the portion not shipped is a key component of the product, (e.g., shipping of computer peripherals without the CPU)
- Shipments to and held by a freight forwarder pending return to the company for required customer modifications
- Sales of merchandise shipped in advance of the scheduled shipment date without the customer's agreement or assent
- Pre-invoicing of goods in process of being assembled or invoicing prior to, or in the absence of, actual shipment
- Shipments made after the end of the period (e.g., the books are kept open to record revenue for products shipped after period end)
- Transactions involving the application of the percentage-of-completion method of accounting in which overly optimistic estimates are used
- Sales not based on actual firm orders to buy
- Transactions involving related parties
- Sales involving dated payment terms or installment receivables
- Sales with terms outside the normal credit policies of the entity
- Contingent sales in which payment depends on:
 - Buyer receiving financing from another party
 - Buyer reselling the product to another party
 - Fulfillment by the seller of certain terms and conditions
 - Acceptance of the product by the buyer after a certain evaluation period
- Sales that require continued seller involvement after the sale such as installation, or other significant support (e.g., software sales requiring installation, debugging, extensive modifications, or other significant support commitments, etc.)
- Sales that are shipped to customers without customer authorization
- Shipments of goods to company-owned warehouses
- Sales to fictitious customers
- Sales based on shipments made on canceled or duplicated orders
- Invoicing goods in advance of being assembled

- Invoicing goods prior to shipment (bill-and-hold goods)
- Complex and unusual sales transactions in which the accounting or finance department has no involvement
- Sales in which substantial uncertainty exists about either collectability or the seller's ability to comply with performance guarantees
- Barter transactions
- Sales booked on cost overruns before the customer agrees to pay for them

Auditors may want to approach the following *two areas* with skepticism:

- a. Last minute sales, and
- b. Sudden changes in the way the business is conducted.

Audit considerations- revenue fraud:

Consider the effect of revenue side agreements:

Improper revenue recognition continues to be a major cause of financial statement misstatements, whether intentional or unintentional. Of particular focus is the presence of side agreements in which hidden agreements are used to alter the terms and conditions of recorded sales transactions to entice customers to accept delivery of goods or services. The result is that certain obligations and contingencies may be created such as financing arrangements or product installation or customization that may relieve the customer of the typical risks and rewards of ownership. In such situations, the transaction is not complete and the sale should not be recorded.

Examples of arrangements that may result in the improper recognition of revenue include:

- Shipping goods to customers without customer authorization
- Shipping goods to company-owned warehouses and billing fictitious customers, and
- Making sales arrangements that obligate the customer to pay only if the goods are resold or dating payment terms well into the future.

In these cases, traditional audit tests make it difficult to uncover special customer arrangements consisting of aggressive payment and shipping terms. Consequently, the auditor is most vulnerable in those cases because:

- Receivables are not collected prior to the end of the audit, or
- Goods are returned after the auditor completes his or her field work.

Given the creative deal-making between sellers and their aggressive buyers, the auditor should be aware of transactions where the sale, in essence, is *not deemed complete* and should not be recorded. In these situations, the auditor must be familiar with the accounting treatment covered in ASC 605-15-25, *Revenue Recognition-Products- Recognition* (formerly FASB No. 48).²³

ASC 605-15-25 (formerly FASB No. 48), states that if an entity sells its product but gives the buyer the right to return the product, the revenue shall be recorded only *if all* of the following conditions have been met:

- a. The seller's price to the buyer is *substantially fixed* or determinable at the date of sale.
- b. The buyer has paid the seller, or the buyer is obligated to pay the seller, and the obligation is *not contingent on resale* of the product.
- c. The buyer's *obligation would not change* in the event of theft or physical destruction or damage of the product.
- d. The buyer has economic substance apart from the seller.
- e. The seller *does not have any significant obligations* for future performance to directly bring about resale of the product by the buyer, and
- f. The amount of future returns can be reasonably estimated.

Observation: Most sellers give their buyers the right to return the product for reasonable cause. In these traditional cases, the sale is recorded in the year of sale, and the sales returns are recorded in the period in which the goods are returned. If returns are material, a more appropriate method is to record an annual allowance for returns in order to properly match the returns with the revenue in the same period in accordance with ASC 450, *Contingencies* (formerly FASB No. 5). However, ASC 605-15-25 (formerly FASB No. 48) goes well beyond the traditional situations. This Statement essentially refers to transactions that are conditional in nature, and, thus, not really complete. For example, if the seller must perform future services after the sale has been made, then, in substance, has a sale really occurred? If the criteria of ASC 605-15-25 have not been met, the sale is not deemed complete and the sales and related cost of sales should be deferred until the transaction becomes complete.

If side agreements or special customer arrangements do exist, usually few individuals within the entity will be aware of them. Consequently, it may be difficult for the auditor to uncover their existence. Use of standard management representations and other audit procedures relating to the revenue and accounts receivable areas usually will not be adequate audit procedures. In this case, the auditor should consider the use of additional audit procedures that may include:

- 1) *Obtain a sufficient understanding of the client's industry and business:* including its products, its internal control structure over revenue, and its accounting policies and procedures.

²³ In 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606), which supersedes all revenue recognition standards and is effective for 2018 (2019 for nonpublic entities).

- 2) Assign experienced personnel: who can effectively deal with unusual and complex sales contracts and transactions.
- 3) Expand confirmation procedures: In addition to confirming account balances and material revenue transactions, the auditor should confirm relevant terms with customers to obtain assurance that side agreements do not exist. Confirmations should be addressed to a person or persons who would be familiar with the terms of any side agreements such as a person who may be a contract signer and not in the accounts payable department.

The auditor should consider designing confirmations to identify:

- Sales terms and the sales contracts
- Side agreements
- Liberal rights of return

Note: The standard confirmation request (confirming only the outstanding balance) alone does not always provide sufficient audit evidence to determine that only appropriate revenue transactions have been recorded.

- 4) Withhold issuance of the audit report until receivables are realized: The auditor may wish to withhold issuing his or her report until a majority of receivables have been realized or a reasonable period of time has lapsed (60-90 days) after year end during which no significant sales have been returned.
- 5) Include a representation in the management's representation letter: Although not providing a great degree of comfort, management's representation letter should include a representation that either identifies known side arrangements or, indicates that there are no known side arrangements.
- 6) Make inquiries of relevant personnel: The auditor may wish to make inquiries of marketing, inventory control, legal and other personnel who would be familiar with side agreements.
- 7) Analytical procedures: Effective analytical procedures can be used to identify situations that warrant additional audit procedures. Examples include sales volume analyses by the week and month from year to year.
- 8) Read and understand contracts: The auditor should not only understand the entity's normal terms and conditions of sales, but should also read and understand contracts related to those significant transactions that are unusual and complex.

Applying analytical procedures to revenue:

AU-C 240 (formerly SAS No. 99) requires that an auditor perform analytical procedures on revenue. The AICPA's *Audit Issues in Revenue Recognition*, a non-authoritative paper, provides assistance in auditing revenue. In this Paper, the AICPA emphasizes the need to apply analytical

procedures to revenue as part of the audit. The degree to which analytical procedures are used depends on the amount of fraud risk factors identified in the fraud assessment planning stage. AU-C 520, *Analytical Procedures* (formerly SAS No. 56),²⁴ requires that the auditor evaluate significant unexpected differences that are identified by analytical procedures.

The following is a list of those analytical procedures that are suggested in the Paper:

- Compare monthly and quarterly sales by location and by product line with sales of the preceding comparable periods.
- Analyze the ratio of sales in the last month or week to total sales for the quarter or year.
- Compare revenue recorded daily for periods shortly before and after the end of the audit period for unusual fluctuations.
- Compare the gross profit ratio, overall and by product line, to previous years and to budget and consider it in the context of industry trends.
- Compare details of units shipped with revenues and production records and consider whether revenues are reasonable compared to levels of production and average sales price.
- Compare the number of weeks of inventory in distribution channels with prior periods for unusual increases that may involve channel stuffing.
- Compare percentages and trends of sales into the distributor channel with industry and competitors' sales trends, if known.
- Compare revenue deductions, such as discounts and returns and allowances, as a percentage of revenues with budgeted and prior period percentages for reasonableness in light of other revenue information and trends in the business and industry.
- Compare sales credits for returns subsequent to year end with monthly sales credits during the period under audit to determine whether there are unusual increases that may indicate contingent sales or special concessions to customers.
- Analyze the ratio of returns and allowances to sales.
- Compare the aging of accounts receivable in the current and prior periods for buildup of accounts receivable.
- Compare monthly cash receipts for the period under audit to cash receipts subsequent to year end to determine whether receipts subsequent to year end are unusually low compared to the collection history during the months under audit.

²⁴ Effective December 31, 2012, AU-C 520, *Analytical Procedures* replaced SAS No. 56.

AU-C 240's (formerly SAS No. 99's) requirement for special analytical procedures on revenue:

AU-C 240 requires that an auditor must perform analytical procedures related to revenue. The objective of these procedures is to identify unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting.

Examples of analytical procedures related to revenue follow:

- Comparison of recorded sales volume with production capacity-an excess of sales volume over production capacity may indicate the recording of fictitious sales.
- Trend analysis of revenues by month and sales return by month during and shortly after the reporting period. Variations may indicate the existence of undisclosed side agreements with customers to return goods that would preclude revenue recognition.
- Compare revenue to variable expenses (cost of sales, commissions, etc.) for significant fluctuations.
- Review bad debt writeoffs in relation to sales.

Typically, auditors perform tests to consider whether revenue is overstated when the opposite understatement of revenue is just as important. In some instances, management or owners might be motivated to understate revenue because management seeks to reduce taxable income or to shift income to the next period. Auditors should consider management's or owner's motivation in planning the audit in the area of revenue.

Revenue cutoff tests and other procedures:

If sales transactions involve the shipment of a product, revenue cutoff tests are used to test the revenue recognition. To be effective, revenue cutoff tests should be performed in connection with inventory cutoff tests. Examples of effective cutoff tests are as follows:

- Large quantities of merchandise awaiting shipment should be noted during the year- end inventory observation. Example: The auditor should inspect the shipping dock and document large orders that await shipment.
- Significant in-transit inventory at year end and/or significant changes from the prior year.
- An unusual increase in sales in the last few days of the audit period followed by an unusual decrease in the first few days after the audit period.
- Numerous shipping locations.
- Scan the general ledger, sales journal, and accounts receivable for unusual activity.

- Compare operating cash flows to sales by sales person, location, or product.

c. Overstated expenses and liabilities:

Another common financial statement misstatement is to understate expenses and liabilities.

Examples include:

- Improperly deferring expenses and recording them in later periods.
- Failing to record liabilities related to prepaid dues and repayment obligations.

Audit considerations- understated expenses and liabilities:

An auditor might consider performing the following audit procedures to deal with the possibilities that expenses and liabilities could be understated:

- Search for unrecorded liabilities and expenses by examining unrecorded invoices and unmatched receiving reports for a period after the end of the period audited.
- Correlate recorded expenses with the corresponding balance sheet amounts.
- Read minutes of board of directors, shareholders and committee meetings to identify contracts and commitments that may exist.
- Examine contracts, leases, and other agreements and documents for unrecorded liabilities.
- Examine unusual and unexplained trends in accounts payable and accrual balances.

d. Overstated assets:

Another way by which management can commit financial statement fraud is to overstate assets. Examples include:

- Recording non-existent assets, such as cash or receivables, and
- Overstating oil and gas reserves and intangible assets.

Audit considerations- overstated assets:

Auditors should consider performing some or all of the following procedures to deal with the risk that assets could be overstated:

- To the extent possible, confirm cash balances directly with banks and financial institutions, or use alternative procedures to confirm the cash balance.
- Perform a detailed review of management's bank reconciliations.

- If needed, use the work of a specialist to deal with certain assets such as oil and gas reserves, and intangible assets.

e. Auditing undisclosed related-party transactions:

There are indicators of undisclosed related-party transactions that may be symptoms of fraudulent financial reporting. Examples of indicators of potential related-party transactions include:

- Highly complex business practices that may disguise the true economic substance of the transactions
- The existence of unusual, highly complex, and material transactions that may lack a valid business purpose
- Entities that conduct material intercompany transactions with each other and are audited by different CPA firms
- A complex and secretive corporate structure that restricts disclosure of the identity of the shareholders
- Significant and unusual transactions occurring at or near year end that result in significant income recognized
- Significant purchases from new suppliers or sale to new customers during the year that seem peculiar as to their location, quantity, price or terms
- Specific borrowings at below-market terms from unusual sources including unknown private parties
- Guarantees of indebtedness
- Loans made without repayments terms
- Related vendors and customers
- Real estate transactions for amounts different from the appraised value
- Sales or nonmonetary exchanges of recently purchased noncurrent assets at significant gains such as works of art, wine, or other similar artwork.

f. Money laundering:

The AICPA's *Audit Risk Alert* (the Alert) makes reference to the auditor's role in dealing with fraud through money laundering.

Money laundering is defined as:

“The funneling of cash or other funds generated from illegal means through legitimate businesses to legitimize the cash or funds.”

The Alert notes that the gross money laundering product is between \$500 billion and \$1 trillion annually. Businesses that are vulnerable to money laundering include banks and non-banking entities such as gaming and import-export businesses.

Laundering involves three stages explained as follows:

1. Placement: The process of transferring the actual criminal proceeds into the financial system in such a manner as to avoid detection by financial institutions and government authorities.

Examples include:

- a. Structuring cash deposits into legitimate bank accounts, converting cash into monetary instruments, and then using the instruments to make investments.
 - b. Customers making large deposits and investments with laundered proceeds in the form of monetary instruments, bearer securities, or third-party checks.
2. Layering: The process of generating a series of layers of transactions to distance the proceeds from their illegal source and to blur the audit trail. Examples include:
 - a. Electronic funds transfers through a bank secrecy haven.
 - b. Withdrawals of already-placed deposits in the form of highly liquid investments.
 - c. Account transfers or checks payable to third parties with whom the holder appears to have no obvious relationship.
 3. Integration: In this stage, the funds are reinserted into the economy through spending, investing, lending and cross-border, legitimate-appearing transactions.

Audit considerations for money laundering include:

- a. Money laundering is less likely to be detected in a financial statement audit than other types of fraud.
- b. Assets are more likely to be overstated than understated.
- c. There is likely to be short-term fluctuations in account balances rather than cumulative changes.

- d. Money laundering is considered an illegal act with an indirect effect on the financial statements.

Audit requirements- money laundering:

If an auditor becomes aware of the possibility of illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically aimed at determining whether an illegal act has occurred. Laundered funds and their proceeds are subject to asset seizure and forfeiture by law enforcement agencies that could result in material contingent liabilities during prosecution and adjudication cases.

Periodically, the Financial Action Task Force (FATF) and the U.S. Treasury Department issue blacklists of governments that are non-cooperative in combating money laundering.

Possible factors of money laundering include transactions that appear inconsistent with a customer's known legitimate business or personal activities or means, and unusual deviations from normal account and transaction patterns.

Examples of suspicious transactions that may indicate that money laundering is occurring include:

- Unauthorized or improperly recorded transactions with inadequate audit trails
- Large currency transactions made in exchange for negotiable instruments or for the direct purchase of funds transfer services
- Structuring currency transactions to avoid the \$10,000 reporting requirement
- Businesses that seek investment services when the source of funds is not available or difficult to determine
- Premature redemption of investment vehicles with requests to remit proceeds to unrelated third parties
- The purchase of large cash value investments followed by heavy borrowing against them
- Large payments received from foreign locations
- Purchases of goods, services and currency at below-market prices
- Using multiple-auditors and advisors for related entities and businesses
- Using companies, trusts and LLCs/partnerships that have no apparent business purpose

10. Anti-Fraud Measures

According to the *2016 Report to the Nation on Occupational Fraud and Abuse*, published by the Association of Certified Fraud Examiners, only one percent of frauds are initially detected through effective internal controls. Yet, strong internal control measures continue to be an entity's first line of defense against fraud. What is apparent is that there is a significant gap between companies' need for effective internal controls and their actual use in preventing fraud.

In its report entitled *Fraud Risk in Emerging Markets*²⁵, the authors note the following based on a survey conducted of their clients:

²⁵ *Fraud Risk in Emerging Markets*, Ernst & Young.

- a. Respondents rated strong internal controls as the number one factor in preventing fraud.
- b. Since the last survey was first conducted, the prevalence of anti-fraud policies has not significantly increased.
- c. 58% of surveyed companies have a formal anti-fraud policy.
- d. Companies that have anti-fraud policies communicate them to their employees but fail to communicate them to their suppliers and customers, agents, intermediaries and joint venture partners.
- e. Training is key to the success of an anti-fraud policy, yet companies are not devoting enough fraud training for their employees.

Note: 72% of those surveyed do not provide their employees with training to implement their entity's anti-fraud policy.

- f. Fraud is more prevalent in emerging markets with corruption and bribery being disproportionately higher in those markets than all other markets.

| Frauds that pose the greatest risk | | |
|---|-------------------------|--------------------|
| <u>Type of fraud</u> | <u>% of respondents</u> | |
| | <u>Emerging markets</u> | <u>All markets</u> |
| Corruption and bribery | 48% | 20% |
| Fraud due to collusion with third parties | 20% | 31% |
| Financial statement fraud | 10% | 20% |
| Theft | 14% | 18% |

Note: The survey states that emerging markets are far more susceptible to fraud due to several factors including a) the rapid growth, b) the immature fraud prevention and detection systems, and c) the limited understanding of fraud risks that typically exist in those markets.

The survey also notes that many companies do not include the greater risk of fraud in their list of risk factors used to evaluate their investment decision in emerging markets. Moreover, 20 percent of entities that consider investments in emerging markets choose not to make such an investment based primarily on their fraud risk assessment.

The authors of the survey reach the following conclusions:

- Building around a focus of internal controls, companies need to develop anti-fraud controls into a formal, documented anti-fraud program.
- Compliance and enforcement are key elements of an effective anti-fraud program, while paper programs that exist only for documents are of no use.

- An effective anti-fraud program must align closely with the most significant fraud risk factors facing an entity.
- Companies must move from a mere notification and education of policies and standards approach to fraud prevention, toward a corporate culture that lives its ethical values worldwide.
- The tone at the top is critical to the success of any anti-fraud program.
- Companies need to quickly implement anti-fraud controls in all new operations in emerging markets in order to offset the effect of different local business practices.
- Companies must establish criteria to govern the escalation of allegations of fraud to help assure the appropriate oversight and composition of investigative teams.

What about employee hotlines?

It is quite clear that the most effective method by which to catch employee fraud is through a fraud hotline. Anonymous tips given through fraud hotlines accessible by employees, customers and suppliers are very effective in reducing fraud.

In fact, despite the legal protection given to whistleblowers, their use and effectiveness is de minimis as compared with an anonymous tip hotline. One reason is that employees do not want the disruption and risk associated with being a known whistleblower. The threat of retaliation from management makes whistleblowing a risky and least attractive option.

Here are some suggestions on how to set up a hotline:²⁶

- Demonstrate and communicate support for the hotline from the top of management.
- Link the recovery from fraud to a reward system under which recovered losses will be distributed or donated to a charity.
- If applicable, involve trade union representatives with the hotline.
- Advertise the hotline through company intranets, posters, training programs.
- Make sure all hotline reports are handled sensitively and anonymously.
- Train specialists in both audit and security to handle the reports or even outsource it.
- Make sure that immediate and strict disciplinary action is taken against those found to abuse the system.

²⁶ *Making Employee Hotlines Work*, Charles Carr, Kroll Global Fraud Report.

11. Sentences for Fraudsters

What is the appropriate sentence for fraud- 6 months, 24 years, 150 years or death?

With all the frauds that have been prosecuted in the past few years, there is a debate going on as to what is the appropriate punishment for one who commits fraud. The range of sentences worldwide is expansive.

On one end of the spectrum, there was a series of cases in which sentences appeared not to be extensive:

Consider:

- Michael Resnick, CFO of Royal Ahold NV's U. S. Foodservice Inc. He pleaded guilty to playing a key role in the huge fraud committed, but was sentenced only to six months of home detention and three years of probation.
- Jeffrey Skilling, former Enron CFO who was sentenced to 24 years in federal prison even though he has appealed to have certain portions of his case thrown out in light of the U. S. Supreme Court's recent ruling on "honest services."
- New York attorney Marc Dreier received only a 20-year sentence for his \$400 million Ponzi scheme, even though prosecutors sought 145 years.

But, in the past couple of years, it appears that the courts have little appetite for fraudsters as U.S. sentences for fraud are getting significantly longer.

The tide is certainly turning as courts look at white-collar fraud crime far more seriously than they used to. The days of spending five years in a "country-club" prison for committing fraud, apparently are gone.

In fact, the courts have issued sentences for fraud that exceed those for first-degree murder. (On average, murderers serve seven years of their sentences.)

Let's take a look at some of the most recent fraud cases:

- Bernie Madoff got 150 years for his massive \$60 billion fraud. But 150 years is certainly not the longest issued in the past few years.
- A federal court handed out a sentence to 72-year old Norman Schmidt for 330 years for an investment scheme. 330 years was the longest sentence issued in a federal white-collar case in Colorado, and most likely anywhere else.
- Virginia authorities sought a 400-year sentence against Edward Hugh Okun in a \$126 million fraud case. Okun used more than \$40 million of escrow funds held for clients

involved in IRC Section 1031 (like-kind exchange) transactions. Although the authorities wanted 400 years, in the end, the 58-year old Okun received a sentence of 100 years. Why such a long sentence? A key factor that that influenced the long sentence was the fact that Okun stole risk-free escrowed funds as compared with Madoff investors who were fully aware that their funds were invested.

- R. Allen Stanford was sentenced to 110 years for his fraud committed in a Ponzi scheme. Prosecutors wanted 230 years.

Even though the sentencing guidelines for fraud are between 5-15 years, the courts appear willing to punish fraudsters with much longer sentences as a deterrent against future frauds being perpetrated.

So, what is the “right” sentence?

No one really knows. But here is what is clear. If you are a fraudster, do not do business in China. The Chinese may be taking fraud more seriously than their U.S. counterparts, particularly in the case of a fraud committed at the China Construction bank. In this case, Zhou Limin, the former head of the Bank and its accountant, Lui Yibing stole approximately \$30 million from 30 organizations and 400 individuals, of which only \$900,000 has been recovered. A Chinese court sentenced both of them to death. They lost their appeal.

In another case, in 2016, the Chinese government issued a harsh sentence to another fraudster. A Chinese perpetrator in a \$1.5 billion Ponzi scam that cheated 230,000 victims, was sentenced to life imprisonment by the Chinese court.

12. A Fraud Scorecard

What if a company could be rated for its susceptibility to fraud; that is, get a fraud scorecard? Would it help predict future frauds?

A research report was published entitled *Predicting Material Accounting Manipulations*²⁷ addresses how one can calculate a “fraud score” for public companies. The study and its conclusions were based on a sample of 680 companies with alleged financial statement fraud.

Specifics from the Report follows:

1. General characteristics of firms committing financial statement fraud (financial statement manipulation):
 - a. Most companies manipulate more than one income statement line item with revenue being the most common as follows:
 - Revenue: 55% of the cases

²⁷ *Predicting Material Accounting Manipulations*, Patricia M. Dechow, et al.

- Inventory and cost of goods sold: 25% of the cases
- Allowances: 10% of the cases

b. Most common industries for manipulations are:

- Computers and computer services
- Retail
- Telecom and healthcare

c. 15% of the manipulations occur in the largest companies.

2. Elements found in financial statements of manipulating firms:

a. Companies have shown strong performance prior to the manipulation.

- The manipulations appear to have been motivated by managements' desire to disguise a moderating financial performance.
- In years leading up to a manipulation, stock returns outperformed the overall market

In the year of the manipulation:

- Stock returns underperform the overall market
- Rates of return were declining
- There are unusually high PE ratios and market to book ratios with investors having high expectations for returns.
- High issuance of debt and equity
- Cash profit margins decline
- Earnings growth declines
- Accruals increase
- Sales order backlog declines
- Employee headcount declines
- Demand for product declines
- Abnormal increases in leasing activity to provide financing flexibility

Example: In 20X1, 20X2 and 20X3, Company X has excellent performance and its stock price outperforms the market. In 20X4, the performance and stock price appear to sliding downward.

Conclusion: In 20X4, Company X manipulates its financial statements to disguise the downward trend from excellent years in 20X1, 20X2 and 20X3.

3. The fraud (manipulation) prediction model- the “*F Score*”

The manipulation prediction model is based on the characteristics of companies along five dimensions that are used to develop the “*F Score*.”

The F Score is a predictor of financial statement manipulation. The higher the score, the higher the likelihood that a company will manipulate its financial statements. An F Score of 1.00 or higher represents a candidate with a high probability to manipulate its financial statements while less than 1.00 is a lower probability. According to the Study, 50 percent of manipulating companies have F-Scores in the top 20 percent of all companies. In creating an F Score, the model uses five factors.

a. Accrual quality:

- Combination of several formulas (see discussion below)

b. Financial performance:

- Rates of return decline
- Earnings growth rates decline

c. Non-financial measures:

- Sales backlog decline indicating a weaker product demand
- Abnormal reduction in number of employees²⁸

d. Off-balance sheet activities:

- Use of operating leases to eliminate debt and improve cash flow
- Higher than usual returns on pension plans to reduce pension expense

e. Market-based measures:

- PE ratios and market-to-book ratios decline

Observation: The accrual quality measurement is a function of several formulas including:

²⁸ An abnormal decline in the number of employees occurs when the % reduction in employees exceeds the % reduction in total assets.

Sloan accruals: Change in current assets (excluding cash) less changes in current liabilities (excluding short-term debt), less depreciation.

RSST accruals: Changes in long-term operating assets and long-term operating liabilities.

Change in receivables: Manipulation of receivables improves sales growth which is an important metric looked at by investors.

Changes in inventories: Manipulation of inventory levels improves gross margin.

Observation: The study performed a retrospective look at Enron in year 2000 and found that Enron would have had an F Score of 1.85 which is almost twice the probability of being a firm that commits fraud.

Conclusion of the study: The Study correctly identified 60% of manipulating firms in advance. In the year a company is performing financial statement manipulation, certain key factors are typically present in order to hide a slowdown in financial performance and maintain high stock price:

- Accrual quality is low
- Financial and non-financial measures of performance are deteriorating, and
- Financing activities and off-balance sheet transactions are more active

Because the Study correctly predicted 60% of manipulation cases, the F-Score can be used as an effective measurement and predictor of fraud in an audit.

13. Computer Crime and Theft

Many companies focus on safeguarding their tangible assets such as inventory and fixed assets. Yet, perhaps right in front of them is their most critical asset; their computer data and other proprietary information.

According to the *CSI/FBI Computer Crime and Security Survey*, the four most expensive computer crimes that account for 74% of all losses were:

- Viruses
- Unauthorized access
- Laptop and mobile hardware theft, and
- Theft of proprietary information.

Who is most likely to commit computer crime?²⁹

²⁹ From *Protecting Data Sources From Internal Theft*, Alan Brill.

Company employees are most likely to engage in computer theft than external parties. The primary reason is access. Employees already have access inside firewalls, intrusion detection devices, and other detection systems.

The concern is not only with existing employees, but also previous ones. In one report, consider the fact that 33% of computer fraud was committed by existing internal employees while 28% was committed by former employees and their partners who still had access to information.³⁰

Moreover, often disgruntled employees are the perpetrators of computer and information fraud and typically use of the following techniques:

- Email: 80% of employees admit to sharing confidential information with outsiders through email.
- Instant messaging: Employees use IM tools to transfer files and send small amounts of text.
- Flash/thumb drives: Significant volumes of data can be transferred via drives in a short period of time.
- Digital cameras: Employees can take pictures of sensitive information and documents.
- Other small data storage devices: Other devices such as Smart Phones can be used to carry data outside the organization.
- Wireless-based gadgets: Wireless routers and networks and Bluetooth dongles allow an employee to connect a cell phone or PDA to a computer and transfer data.

The lesson is that an effective information fraud program must deal with everyone who has access to sensitive information including current and past employees, part-timers and temporary employees, and outsourcing companies that deal with confidential data.

14. Integrity Survey

Corporate integrity has become more important as companies, regulators, and investors look for a better understanding of factors that may have contributed to the various economic issues that existed in the marketplace along with corporate fraud and misconduct.

Based on a *KPMG Integrity Survey*, employees are facing greater pressure to meet revenue and cost targets that may drive them to using improper means to do so, particularly if they believe their jobs would be in jeopardy.

According to the survey:

³⁰ *The Global State of Information Security*, PWC.

1. Misconduct in corporate America remains high with 74 percent of the employees surveyed reporting that they have personally observed or have firsthand knowledge of wrongdoing within their organizations during the past year.
2. 46% reported that if the misconduct were to be discovered, it would cause a significant loss of public trust in the organization. 60% of employees from the banking and finance industry noted a significant misconduct.
3. Major drivers of fraud and misconduct were:
 - 59% feel pressure to do whatever it takes to meet business targets.
 - 52% believe they will be rewarded for results regardless of the means to achieve them.
 - 50% lack resources to get their jobs done without cutting corners.
 - 49% fear losing their jobs if they do not meet their targets.
4. Although whistleblowing actions have increased, it remains a risk that boards and management may not hear from employees until it is too late.
 - 57% stated they would feel comfortable using a hotline to report misconduct, which is an increase from the previous survey which had only 40% of the respondents.
 - 53% believed they would be protected from retaliation.
 - 39% believed they would be satisfied with the outcome if they reported misconduct to management.
5. Types of misconducts included:

From the survey, respondents identified the following misconducts as those they had either engaged in or witnessed being committed within their organizations.

| Types of Misconducts Perpetrated or Witnessed | |
|---|-------------------------|
| Type of misconduct committed | <u>% of respondents</u> |
| Violating workplace health and safety rules | 47% |
| Discriminating against employees | 47% |
| Wasting, mismanaging, or abusing organization resources | 44% |
| Engaging in sexual harassment | 38% |
| Violating employee wage, overtime, and benefit rules | 28% |
| Breaching employee privacy | 28% |
| Engaging in false or deceptive sales practices | 27% |
| Entering into supplier contracts that lack proper terms, conditions and approvals | 26% |
| Abusing drugs and/or alcohol at work | 26% |
| Mishandling confidential or proprietary information | 24% |
| Violating or circumventing supplier selection rules | 24% |
| Fabricating product quality or safety test results | 23% |
| Violating environmental standards | 23% |
| Breaching computer, network, or database controls | 22% |
| Falsifying time and expense reports | 21% |
| Engaging in activities that pose a conflict of interest | 20% |
| <i>KPMG Integrity Survey</i> | |

The respondents suggested that the following actions could be taken to mitigate the effects of misconduct and provide an environment of a high-integrity organization.

- a. Have a tone at the top with local managers and supervisors, and CEOs and other senior executives that are positive role models.
- b. Create a team culture and work units that are motivated and empowered to do the right thing.
- c. Have channels within which employees can feel comfortable to report misconduct without retaliation.

Observation: In today's litigious environment, it is important the companies and their boards establish an ethics and compliance program and that they exercise regular oversight of that process. There have been several recent cases where shareholders have sued their companies and their boards for damages resulting from employee misconduct. The fact that a company has an ethics compliance program and that the board exercises reasonable oversight over that program generally have shielded the board from personal liability in recent cases.³¹

³¹ See Stone v. Ritter, C. A. (Delaware, November 6, 2006) as noted in the KPMG report.

15. Correlation Between Bankruptcy and Fraud

Is there a high correlation between a company that goes bankrupt and one that commits fraud? Is an entity that has fraud perpetrated more likely to file bankruptcy?

A study published by Deloitte Touche addresses these issues.

The Study³² is based on a review of the bankruptcy filings of more than 1,000 publicly traded companies over a six-year period, and approximately 400 companies that had been issued SEC Accounting and Auditing Enforcement Releases (AAERs) over an eight-year period.

The results concluded:

1. Bankrupt companies were *three times more likely* to be issued financial statement fraud AAERs by the SEC subsequent to the bankruptcy filing.
 - a. The fact that a large publicly traded company files for bankruptcy is an event that attracts the SEC's attention.
 - b. 69% of the SEC's AAERs were issued within three years after the entity filed bankruptcy.
 - c. Bankrupt companies were twice as likely to have more than 10 fraud schemes in their history.
2. Companies issued financial-statement-fraud AAERs were more than twice as likely to file bankruptcy as those not issued one.
 - a. One in seven AAERs was issued against companies prior to those companies filing for bankruptcy, suggesting that AAERs may be a warning sign for filing a future bankruptcy.
 - b. Company morale at troubled companies along with pressure to reach lofty budgets can create an environment to perpetrate fraud.
 - c. The most common types of financial statement fraud for bankruptcy companies were revenue recognition, manipulation of expenses, and improper disclosures.

16. The CFO Perspective on their Outside Auditors and Fraud

One recent survey of CFOs demonstrates the challenges auditors have in discovering fraud. In the survey, the majority of CFOs stated that they believe it would be possible to intentionally misstate their financial statements with their auditor not discovering the misstatement.

³² *Ten Things About Bankruptcy and Fraud*, Deloitte Forensic Center.

- 62% believe it would be possible to intentionally misstate their company's financial statements.
- Only 17% believe it is possible for auditors to detect any and all corporate fraud.³³

The results of the CFO survey are somewhat disturbing in light of the psychology of fraud. In general, the fraud triangle provides that typically, three elements exist in a fraud: incentive/pressure, opportunity, and rationalization/attitude. If a CFO believes he or she can commit a financial statement fraud that is not likely to be detected by the outside auditor, that assumption creates a heightened environment with respect to the existence of one of the three elements: the CFO perceiving that he or she has an opportunity to commit fraud.

17. Madoff and the Single Auditor Issue

Four years after Bernie Madoff turned himself into the Authorities, the cases involving Madoff, his family, and the hundreds of victims and perpetrators, are still in the courts.

In hindsight, commentators assert that there were numerous "red flags" that supported a conclusion that Madoff was perpetrating a massive fraud and that various parties should have read those signals to avoid the fraud from occurring in the first place.

Some of the signs identifying that fraud existed include:³⁴

- All key players in the Madoff organization were family members.
- The Madoff funds allegedly earned returns significantly higher than the market for similarly risked investments.
- The investment returns were too consistent for an otherwise volatile equity market.
- Madoff's investment funds had poor transparency.
- Madoff used a sole auditor.

Of particular focus in recent articles and studies is the fact that Madoff's auditor, Friebling & Horowitz (F&H), had a very small operation when compared with the scope of Madoff's operations. In essence, the F&H operation was a sole practitionership with a second partner retired in Florida.

Since the Madoff scandal broke, numerous CPA firms that represented "feeder funds" have been sued. Although these feed funds had reputable CPA firms and investment advisors, the underlying investment assets were held by Madoff. Consequently, there are questions that are now at the forefront of the Madoff audit controversy:

³³ Survey by Grant Thornton, LLP

³⁴ *Bernard Madoff and the Sole Auditor Red Flag*, Fuerman, Journal of Forensic & Investigative Accounting.

Is the use of a sole practitioner who audits a disproportionately larger company (Madoff fund) a red flag?

Although some commentators state that the fact that the Madoff auditor was a sole practitioner was, in and of itself, a red flag, nothing in GAAS states that the size of a CPA firm has anything to do with the quality of the audit work and the experience of the auditor.

There were, however, several key signs that should have been observed in assessing the Madoff auditor that included:

- He was not registered with the Public Company Accounting Oversight Board (PCAOB), which was required by the SEC in connection with the Madoff investment funds.
- He had not been subject to New York state peer review.

Regardless of whether it is valid, the Madoff fraud has brought to the forefront a debate as to whether sole practitioners have the ability to perform a quality audit for larger organizations.

In a report entitled, *Bernard Madoff and the Sole Auditor Red Flag*,³⁵ the author of the Report performed an investigation as to whether a company's use of a "solo auditor" is a red flag. The Report was based on a study of 396 non-Big 4 litigations occurring during the period 1996 to 2008. The data was separated by size of CPA firm based on medium (six largest non-Big 4 CPA firms), small CPA firms, very small CPA firms (2-9 accountants), and solo practitioners.

From the sample, the author of the Report evaluated the percentage of lawsuits against audit clients, in which the CPA-auditor was also named as a defendant. The assumption was that if an audit client is sued, but the CPA-auditor is not sued, the audit quality must be high. Conversely, if the CPA-auditor is also sued along with the audit client, the audit quality must be low.

Conclusions reached by the Report and other studies include:

- a. Audit quality is positively associated with CPA firm size. The larger the CPA firm, the more it will invest in monitoring its partners because the firm's reputation capital is so valuable.
- b. A solo auditor raises a red flag, although like any red flag, it proves nothing, and requires further investigation.
 - Where a principal auditor is required to make inquiries concerning the professional reputation and independence of the other auditor, such inquiries have heightened importance whenever the other auditor is a solo auditor.

Observation: Although the previous Report suggests that audit quality is lower in smaller firms (in particular sole practitioners), one cannot apply this conclusion across the entire population of

³⁵ *Bernard Madoff and the Solo Auditor Red Flag*, Ross D. Fuerman.

sole practitioners. The reality is that most sole practitioners do an excellent job in performing their engagements, including audits. Like all professionals, there are always examples of professionals that miss the mark and perform sub-par engagements. Certainly, the failure of the Madoff audit should not be construed as a reliable example of how other sole practitioners perform their engagements. Instead, the Madoff auditor had other signs of deficiency including his failure to register under the PCAOB and not going through peer review.

What were the warning signs that Madoff was a fraudster?

The smartest people in the room can identify a list of early warning signs that suggested that Madoff was engaged in a fraud. Using hindsight to identify fraud warning signs is like looking at Nostradamus's predictions after the events occur. After the fact, it is easy to see the obvious.

There are extensive studies, reports, and analyses that have been published since the Madoff fraud was uncovered, each with its own twist as to how obvious the fraud signs were. Yet, those same authors were nowhere to be found during the twenty years in which Madoff perpetrated his fraud. The SEC, analysts, family members, accountants (most), lawyers, and others were all conned over an extensive span of twenty years. Only one analyst, Harry Markopolos, CPA, had the analysis and conviction to determine that Madoff could not be legitimately generating the above-market returns over an extended period of time. When Markopolos contacted the SEC about his fraud theory, the SEC ignored him. Exclusive of Markopolos, other professionals were fooled by Madoff in a scam that seems obvious in hindsight, but was not identified during the period in which the fraud was committed.

One particular analysis looks into the psychological profile of Madoff as a predator, who fed off the people around him.

According to this one study, Madoff had the profile of a predator, based on the following attributes:³⁶

- It is likely that Madoff's family (wife and two sons) were kept in the dark about the fraud.
- Madoff had the need to look successful, with expensive suits, private jets, yachts, etc.
- Madoff had a lack of trust and engaged in secrecy with cameras in his office, lack of access to his 17th floor.
- People around Madoff feared him and his temper.
- Madoff lied on a regular basis to the SEC, bankers and analysts.
- Madoff was dishonest, including having several affairs for which he had to pay out "hush money."

³⁶ *Bernie Madoff: Predator of His Own Kind*, Terry A. Sheridan, Ph.D.

- Madoff had several obsessions including obsessive compulsive disorder (OCD) such as obsessive cleanliness and orderliness.
- Madoff had odd, eccentric behaviors including extensive blinking, elimination of email access, dropping his pants in public, etc.
- Madoff was unwilling to apologize for his fraud.
- There were stress cracks in Madoff's mask of appearance including temper tantrums.
- Madoff continued with the facade even after he was caught.
- Madoff had a superiority complex.
- Madoff was a sociopath in that he was capable of lying, manipulation, the ability to deceive, feelings of grandiosity and callousness toward his victims.

Observation: As previously discussed in this course, the fraud triangle includes three elements: incentive or pressure, opportunity, and rationalization or attitude. Madoff's profile as a predator is an example of how a fraudster can rationalize his fraud. Studies have confirmed that many fraudsters rationalize their fraud as representing compensation that is owed to them. In general, they do not see themselves as committing a fraud. Madoff was able to rationalize his fraud and certainly demonstrated no remorse with his failure to apologize to his victims. In fact, in prison, Madoff was quoted as stating that he carried his investors for 20 years and he was now doing 150 years in prison.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. According to one study, *Is Time Theft Robbing You Blind*, who is more likely to steal time from their employer:
 - a. Employees age 30 and older
 - b. Employees in high-ranking positions
 - c. Manufacturing personnel
 - d. Temporary employees
2. According to the AICPA's Audit Risk Alert, what "circumstance and observation" might serve as a warning sign of fraud:
 - a. A small company that has a large company mentality
 - b. Compensation plans that are established to help generate profits
 - c. The company experiences success over continued periods
 - d. Sales are growing faster than receivables
3. To help mitigate inventory fraud schemes, at the planning stage the auditor should perform certain procedures. Which of the following are examples of such procedures:
 - a. Make test counts in areas in which the auditor has traditionally focused in past audits
 - b. Review client procedures to integrate consigned goods from the inventory
 - c. Take the physical inventory at all significant locations at the same time
 - d. Become familiar with the client's business and its products or services
4. Which of the following is an indicator of potential related-party transactions:
 - a. A single CPA firm audits entities that conduct material intercompany transactions with each other
 - b. The appraised value of real estate is different from the real estate transaction
 - c. Significant transactions occurring throughout the year that result in significant income recognized
 - d. Specific borrowings at market terms
5. In what stage of money laundering are the funds reinserted into the economy through spending, investing, lending and cross-border, legitimate-appearing transactions:
 - a. Funneling
 - b. Integration
 - c. Layering
 - d. Placement

SUGGESTED SOLUTIONS

1. According to one study, *Is Time Theft Robbing You Blind*, who is more likely to steal time from their employer:
 - a. Incorrect. The study found that employees under age 30 steal more time than employees age 30 and older.
 - b. Correct. The study found that employees in a greater position of seniority have a greater chance of stealing time from their employer.**
 - c. Incorrect. Manufacturing personnel do not steal as much time as other types of personnel. For example, the study found that office personnel steal more time than manufacturing personnel.
 - d. Incorrect. The study found temporary employees do not steal significant time. Permanent employees steal more time than temporary employees.

2. According to the AICPA's Audit Risk Alert, what "circumstance and observation" might serve as a warning sign of fraud:
 - a. Incorrect. A "circumstance and observation" that might serve as a warning sign of fraud is a *large company* that continues to have a *small business mentality*, and not the other way around. A large company's management may still retain control of the internal control environment even as the company continues to grow. The centralized control of operations creates a greater risk that management might override internal controls.
 - b. Incorrect. One warning sign of fraud is compensation plans that reward management for achieving aggressive financial goals or are geared toward enriching executives, rather than generating profits. Thus, the answer is incorrect. One should be aware of the power of greed in motivating management and other employees to take actions they might not otherwise take.
 - c. Correct. An example of a warning sign of fraud might be continued periods in which the company experiences success with no peaks and troughs in the business cycle. The reason is because management may inappropriately make decisions without taking into account the typical ups and downs in the business cycle.**
 - d. Incorrect. A warning sign of fraud is when *receivables* grow faster than *sales*, not the other way around. If sales are declining, management may attempt to inflate receivables to improve its financial position.

3. To help mitigate inventory fraud schemes, at the planning stage the auditor should: perform certain procedures. Which of the following are examples of such procedures:
 - a. Incorrect. *During the physical count*, the auditor should make test counts in areas in which the auditor has not historically focused to surprise the client. Taking physical accounts in areas historically focused on by the auditor allows the client to predict where and when the auditor will perform audit procedures.
 - b. Incorrect. When inventories are held for or by others, the auditor should review client procedures to segregate, not integrate, consigned goods from the inventory.
 - c. Incorrect. When *inventory is at multiple locations*, the auditor should take the physical inventory at all significant locations at the same time to avoid the risk of double counting the same inventory.

- d. **Correct. An important part of planning for inventory observation is for the auditor to understand the client's business, its products, computer processing applications and relevant controls, and cutoff procedures before physical counts are taken.**
4. Which of the following is an indicator of potential related-party transactions:
- a. Incorrect. An indicator of potential related-party transactions is entities that conduct material intercompany transactions with each other and are audited by *different* CPA firms, and not the same CPA firm. Thus, the answer is incorrect.
 - b. **Correct. An indicator of potential related-party transactions is where real estate transaction is consummated at an amount that is different from the appraised value, suggesting there is related-party bias in the valuation. For example, if real estate with an appraisal value of \$1,000,000 is sold to a related party for \$500,000, that fact might suggest that there is related-party bias in the transaction.**
 - c. Incorrect. An indicator of potential related-party transactions is significant *and unusual* transactions occurring *at or near year end* that result in significant income recognized. Significant transactions occurring throughout the year by themselves, are not an indication of related-party transactions.
 - d. Incorrect. An indicator of potential related-party transactions is specific borrowings at *below-market* terms *from unusual sources including unknown private parties*. Market value borrowings do not indicate the existence of related party transactions.
5. In what stage of money laundering are the funds reinserted into the economy through spending, investing, lending and cross-border, legitimate-appearing transactions:
- a. Incorrect. The term "funneling" is part of the definition of money laundering and is not a stage. Money laundering is defined as the funneling of cash or other funds generated from illegal means through legitimate businesses to legitimize the cash or funds.
 - b. **Correct. In integration, the third stage of laundering, the funds are reinserted into the economy through spending, investing, lending and cross-border, legitimate-appearing transactions.**
 - c. Incorrect. Layering, the second stage of laundering, is the process of generating a series of layers of transactions to distance the proceeds from their illegal source and to blur the audit trail.
 - d. Incorrect. Placement, the first stage of laundering, is the process of transferring the actual criminal proceeds into the financial system in such a manner as to avoid detection by financial institutions and government authorities.

SECTION 2: Auditing Developments

IV. Attempting to Limit Auditor's Liability

Auditors on both sides of the Atlantic are trying techniques to limit their liability to their clients and third parties.

Europe is moving ahead with liability limits:

In Europe, auditors have had much greater success with limiting liability than those in the United States. In particular, the Big Four have won several battles to limit their liability, with the most recent victories occurring in the U.K. and Belgium. The goal appears to be to win Europe-wide limits on liability and then attempt a similar cap in the United States. With the size of claims in today's litigious environment, any one of the Big Four is one major claim away from going out of business.

The U.K. government has passed legislation that allows auditors to negotiate with companies for liability caps and provide for proportionate responsibility for losses incurred. The result is that damages against auditors are limited to only a portion of the total amount of loss deemed a direct result of the audit, with management and others absorbing the remainder. Presently, auditors can be liable for all damages if other defendants are insolvent.

In the United States, auditors have been unable to push legislation that would limit liability. As a result, auditors are limiting liability contractually by placing liability caps in their engagements letters. Although the liability cap approach may protect auditors against their clients who are a party to the engagement letter contract, it does not help such U.S. auditors shield themselves against third-party liability.

Why use liability caps in the first place?

Placing liability caps and indemnification clauses in engagement letters is nothing new. Firms in all industries, from architects to CPAs, have used them to limit liability. In the wave of a series of sizeable liability claims against the Big 4, liability cap provisions have given the Big 4 and other firms partial liability protection by limiting the claim settlement due to the client in the event of a lawsuit. Because all of the Big 4 use liability cap provisions to some extent, management and audit committees have little choice but to accept them. This is the risk that exists when there are only four major national accounting firms to perform the super majority of SEC audits.

Liability caps are an effective and secretive way for auditors to limit liability because engagement letters are generally not published in proxy reports. Thus, any liability limits inside the engagement letter may go unnoticed by shareholders and third parties.

Critics of liability limitations claim that auditors should be required to disclose the liability caps and indemnifications in their proxy statements. Recently, the SEC has challenged use of certain types of liability caps used by the Big 4, asserting they taint independence.

To date, the AICPA and SEC have different opinions as to whether an auditor taints his or her independence if he or she enters into an agreement with a client that indemnifies the accountant against losses due to the accountant's or client's negligence. The following table compares each organization's current position on the matter:

| <u>Type of Indemnification Clause</u> | Independence Impaired? | |
|---|-------------------------------|--------------|
| | SEC (1) | AICPA (2) |
| Indemnity against accountant's negligence | Yes | Yes |
| Indemnity against client's negligence | Yes | Yes |
| Indemnity against knowing misrepresentations made by management | Yes | No |

(1) Application of the Commissioner's Rules on Auditor Independence Frequently Asked Questions, Other Matters, Question 4, Section 602.02 of the Codification of Financial Reporting Policies, SEC Office of the Chief Accountant.
 (2) ET sec. 1.228.010 of AICPA Code of Professional Conduct.

Previously, the SEC ruled that an accountant's independence would be impaired if he or she enters into an agreement with an SEC client that indemnifies the accountant for either the accountant's or client's negligence. The SEC's reasoning is based on the argument that the existence of an indemnity agreement may "easily lead to the use of less extensive or thorough procedures that would otherwise be followed."³⁷ To date, there has been little movement in the SEC's position to suggest that SEC company auditors will be permitted to use indemnification clauses in the near future.

The AICPA has taken a different tact as noted in Ethics Ruling No. 94, *Indemnification Clause Engagement Letters*. Specifically, in ET sec. 1.228.010 of the AICPA Code of Professional Conduct, *Indemnification of a Covered Member*, the AICPA has concluded that a clause in which the client indemnifies the auditor from any liability and costs resulting from knowing misrepresentations by management does not impair auditor independence. However, an indemnification of the auditor for client negligence or auditor negligence would impair independence.

Current status

With myriad lawsuits against auditors and accountants, firms are becoming quite aggressive in insisting on indemnification clauses in their engagement letters as a condition of performing the engagement. In particular, with only four major accounting firms to

³⁷ *Application of the Commission's Rules on Auditor Independence- Frequently Asked Questions, Other Matters*

perform the majority of SEC audits, the Big 4 are forcing the indemnification issue. Their actions have trickled down to regional and local firms that perform work primarily for non-SEC companies.

In response to the more active use of indemnification clauses, the Federal Financial Institutions Examination Council (FFIEC) published a document entitled, *Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letter*.

The FFIEC advisory was published in response to the use of indemnification clauses in agreements with various financial institutions. In the Advisory, the FFIEC challenged the use of such clauses stating that such clauses are unsafe and unsound. Further:

1. Agreements by financial institutions to limit external auditor liability may weaken the external auditors objectivity, impartiality, and performance, thereby reducing the ability to rely on external audits.
2. Entering into such indemnity agreements, in connection with either auditor or client negligence, is an unsafe and unsound practice.
3. Financial institutions should be aware that their insurance policies may not cover them if such clauses are included.
4. Financial institutions should be careful not to enter into agreements that mandate Alternative Dispute Resolution (ADR) or waive jury trials.

ET sec. 1.400.060 of the AICPA Code of Professional Conduct (formerly Ethics Interpretation 501-8), *Indemnification and Limitation of Liability Provisions*, further deals with this issue as follows:

Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that:

- prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or
- provide that the existence of such provisions disqualifies a member from rendering such services to these entities.

For example, federal banking regulators, state insurance commissions, and the SEC have established such requirements.

If a member enters into or directs or knowingly permits another individual to enter into a contract for the performance of audit or other attest services that are subject

to the requirements of these regulators, the member should not include or knowingly permit or direct another individual to include an indemnification or limitation of liability provision that would cause the regulated entity or a member to be in violation of such requirements or disqualify a member from providing such services to the regulated entity. A member who enters into or directs or knowingly permits another individual to enter into such an agreement for the performance of audit or other attest services would be considered in violation of the “Acts Discreditable Rule” [1.400.001].

What impact does ET sec. 1.400.060 have on the auditor?

ET sec. 1.400.060 states that an indemnification and/or limited liability clause may not be used if it is prohibited by applicable law or regulation, or violates ethics rulings. Thus, if use of such a clause violates the rules of a regulated entity that would result in the auditor being disqualified from providing the services to that regulated entity, the indemnification clause would be prohibited.

This result does not impact the use of certain indemnification clauses for a non-regulated entity such as a traditional manufacturing or distribution entity. In such a case, use of the indemnification clause would be subject to ET sec. 1.400.060 which is addressed previously.

If an entity is non-public, and not subject to SEC or any other regulatory rulings, an indemnity clause that protects the auditor against known misrepresentations by management does not impair independence.

Examples of clauses and comments: Assume the client is a nonpublic, non-regulated entity

1. Auditor Indemnified Against Claims Based on Knowing Misrepresentations by Audit Client’s Management:

Company X hereby indemnifies Joe Auditor, his partners, principals and employees and holds them harmless from all claims, liabilities, losses and costs arising in circumstances where there was a misrepresentation by the audit client’s management, regardless of whether such person was acting in Company X’s interests.

Conclusion: This clause would not impair independence as it indemnifies auditor against all claims due to client’s knowing misrepresentation.

What if the clause indemnifies the auditor for claims based on the auditor’s negligence?

Example:

Company X hereby indemnifies Joe Auditor, his partners, principals, and employees, and holds them harmless from all claims, whether a claim be in tort, contract, or

otherwise, from any damages relating to services provided under this engagement letter, or

Company X hereby indemnifies Joe Auditor, his partners, principals, and employees, and holds them harmless from all claims, whether a claim be in tort, contract, or otherwise, for any damages relating to services provided under this engagement letter, except to the extent finally determined to have resulted from the gross negligence, willful misconduct or fraudulent behavior of Joe Auditor related to such service.

Conclusion: The above clause would impair independence because it indemnifies the auditor against all claims based on auditor's negligence.

Observation: By indemnifying the auditor for client misrepresentations, there is a significant deterrent to management committing fraud as it shifts to the client the responsibility for making proper representations to the auditor. This type of clause encourages management to completely and accurately disclose and communicate all pertinent matters to the auditor.

The SEC has been quite clear that when an accountant who enters into "an agreement of indemnity which seeks to provide the accountant immunity from liability for his or her own negligent acts... the accountant is not independent."³⁸ If ethics permitted such an indemnification clause, an auditor would be encouraged to perform sub-par work knowing he or she had an insurance policy in the indemnification clause.

Would limited liability be successful in the United States?

There is little evidence that meaningful limited liability reform for auditors is coming to the United States anytime soon. The litigation community continues to be successful in thwarting limited liability for any major profession, including medical professionals and auditors. Simply put, there is too much money to be made when plaintiff lawyers sue the auditors of SEC companies. At this juncture, it is likely that significant reform in limited liability will occur in Europe before it reaches the United States.

U. S. Chamber of Commerce Proposal- Auditor Liability Limitations

"None of us regulators has a clue what to do if one of the Big Four failed.... If one of the Big Four were to collapse, the best accountants could choose to quit the profession."

- William McDonough, former chair of PCAOB

The U. S. Chamber of Commerce came to the rescue of auditors by publishing a report that proposed limiting auditor liability. In its policy paper entitled, *Auditing: A Profession at*

³⁸ SEC, Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence Frequently Asked Questions, Other Matters- Question 4.*

Risk, the Chamber developed a framework to ensure long-term viability of the auditing profession, outlined in a three-point plan that:

1. Assists the profession in becoming insurable
2. Clarifies PCAOB standards, including those related to internal control audits, and
3. Supports expansion and competition of the Big 4 firms.

Conclusions published in the Report follow:

- a. Sarbanes-Oxley has greatly increased the role of auditing in public companies.
- b. The pressure for auditors to do more when conducting audits means that the auditor-client relationship is becoming more involved and continuous, with much more frequent interactions, rather than simply holding periodic discussions.
- c. The auditing profession faces a number of significant legal challenges:
 1. Auditors continue to be the target of a difficult litigation and regulatory enforcement environment.
 - Business losses by a client can result in lawsuits.
 - A single indictment, even without a conviction, can result in the destruction of thousands of jobs, such as in the case with Arthur Andersen.
 - Over-litigation and unfair enforcement are so dire that the profession is essentially uninsurable.
 - Because of the personal financial risk of being an auditor, it is becoming increasingly difficult to attract and retain high-quality personnel to the profession.
 - Audit firms feel they are caught in the middle between the demands of regulators, law enforcement, the plaintiff's bar, and their clients.
 2. The process of developing and interpreting accounting principles remains in flux as business transactions become more complex.
 - There remains significant misunderstanding about the meaning and nature of accounting principles which can translate into significant litigation risk.
 - Changes of one or two cents per share may drive a litigation claim even though such changes indicate nothing about the financial health of the company's underlying business.
 3. The accounting profession is severely contracted, with only four major accounting firms serving a large majority of the listed and actively traded public companies in the United States.

- Any further contraction in the accounting industry would present a major challenge to the viability of the profession.

Recommendations made by the Chamber of Commerce:

In its Report, the Chamber of Commerce recommended that the following actions be taken to save the audit profession.

1. Help the profession become insurable

- a. Better define auditor procedures and responsibility for fraud detection and limit the auditor's responsibility to it.
 - Develop a *safe harbor standard* for fraud detection that clearly defines the nature and extent of procedures an auditing firm must perform to detect fraud.
 - The safe harbor would be developed and approved by both the PCAOB (for public companies) and the ASB for nonpublic entities.
 - Firms that perform under the safe harbor would be protected against legal liability.
- b. Create an Alternative Dispute Resolution (ADR) system for disputes about audits.
 - Juries and non-expert judges cannot properly evaluate arcane accounting judgments and auditing methodologies.
 - A specialized accounting court could also be considered as part of the ADR system.
- c. Permit parties to agree to ADR and reasonable limits on litigation.
 - The SEC and banking regulators need to accept the ability of auditors and their clients to agree to limitations on damages and indemnification provisions.
- d. Regulate threats of indictment against audit firms.
 - The inappropriate indictment of Andersen led directly to the loss of 28,000 jobs in the United States and more than 80,000 worldwide, even though the indictment was subsequently withdrawn.
 - Criminal indictments should be made against the individuals involved in the purported crime and not the firm as a whole.
 - Individuals within the firm who had no knowledge of the criminal activity should not be punished.

- Congress needs to reign in the Justice Department and other regulatory authorities and establish clear rules under which firms may be criminally indicted.
- Firms need a chance to be heard before indictments are issued.

2. Clarify PCAOB standards

- a. The PCAOB has created the environment for overauditing and has the responsibility to clarify its standards and provide safe harbors for auditors allowing them some measure of predictability and freedom from being second guessed.

Example: Previously, the PCAOB issued PCAOB Standard No. 2 (as superseded by PCAOB Standard No. 5), as the primary implementation standard for Section 404 of Sarbanes. PCAOB Standard No. 2 was considered too broad, and principles-based. PCAOB Standard No. 2 also used broad terms as “significant” and “relevant” which needed more explanation. Consequently, auditors were “overauditing” their clients. Ultimately, the PCAOB issued PCAOB Standard No. 5, which superseded PCAOB No. 2 and simplified and clarified the requirements for auditors to deal with Section 404 of Sarbanes Oxley.

3. Support expansion and competition among top-tier firms

- a. The SEC should reexamine regulations that prohibit the Big Four firms from competing for audit assignments when they have performed disqualifying services in prior years.
- b. Remove nonmarket barriers that impede competition with the Big Four.
 - The SEC and PCAOB, among others, should support policies that help the entire profession become insurable since risk management is a huge barrier to growth for any firm seeking to audit public company clients.
 - Clarify and streamline the accounting standards to make it less expensive for firms to stay current with the latest pronouncements.
 - The FASB needs to address the problem of infinite complication in accounting rules, which makes it almost impossible for even the most knowledgeable and well-intentioned accountants to keep up.
 - SEC needs to include non-Big Four firms in the GAAP debate.
 - All parties should encourage public companies to consider high-quality firms outside the Big Four by encouraging Wall Street underwriters and the investing public to accept other choices such as those in the second-tier of national or regional firms.

Can there ever be a Big Five accounting firm?

Although the Chamber of Commerce report has merit, the third recommendation, of creating competition to expand the Big Four, is least likely to happen. Two reports reach the same conclusion; that is, it is virtually impossible to create a fifth national firm the size of the Big Four.

In a GAO report published entitled, *Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* (the Report), the Report reached several conclusions as to the concentration of the Big Four firms and whether action should be taken to increase concentration among them.

1. The Big Four audit more than 98 percent of all U.S. public companies with more than \$1 billion of sales.
 - Midsize and smaller firms audit approximately 80 percent of the smallest public companies with sales of less than \$100 million.
2. Internationally, the Big 4 dominate the market for audit services.
3. Only 40 percent of large companies noted that the number of accounting firms from which they could choose was adequate.
 - In contrast, 75 percent of the smallest public companies stated their number of audit choices was sufficient.
4. 90 percent of large public companies stated they would not use a non Big-Four firm. Reasons noted included:
 - There is lack of capacity for non Big-Four firms to perform the audit.
 - Selecting a Big Four auditor is a prudent and safe move.
 - There is a reputational requirement of using the Big Four by shareholders, banks, lenders, and underwriters
5. More than 70 percent of midsize and smaller accounting firms have no interest in obtaining large public company audits.
6. There is no evidence that the market concentration among the Big Four has any bearing on the significant increase in audit fees in the post-Sarbanes era: Other factors were noted as causing the increase in fees including:
 - Increased complexity of accounting and financial reporting standards that has driven a greater need for technical expertise.
 - Additional auditing standards that have increased the amount of work required
 - Additional work required to prepare for PCAOB inspections.

- Additional work to comply with Sarbanes-Oxley and Section 404 requirements.
7. Because of the barriers to entry, market forces are not likely to result in the expansion of the current Big Four. Smaller accounting firms face significant barriers to entry into the audit market for large multinational public companies for several reasons including:
- Smaller firms generally lack the staff, technical expertise, and global reach to audit large and complex national and multinational public companies.
 - The Big Four had more than five times as many partners and over seven times as many staff as the average for the next four largest firms.

| | <u>Big Four</u> | <u>Next four largest firms (1)</u> |
|---|-----------------|------------------------------------|
| Partners | 8,487 | 1,588 |
| Professional staff | 79,607 | 11,403 |
| Offices | 354 | 227 |
| Public company clients | 5677 | 919 |
| (1): includes RSM (formerly McGladrey), Grant Thornton, BDO Source: GAO Report | | |

8. The results of a further concentration in the Big Four (down to Big Three) would significantly increase the concentration in the audit market. The Report cited several risks that could result in a loss of a Big Four firm including:
- A sizeable civil litigation claim in excess of insurance coverage
 - Criminal prosecution, such as in the case of Arthur Andersen, and
 - A merger of two of the Big Four firms.

What would happen if a Big Four firm goes under?

In the report entitled *The Future of the Accounting Profession: Auditor Concentration*, participants were asked to assess the risks of reducing the Big Four to the Big Three due to the potential loss of one of the Big Four firms.

1. There was significant concern about the potential loss of another Big Four Firm.
- The current degree of concentration raises the specter that the collapse of the Big Four firm would be a threat to the continued existence of the profession.
 - An environment with only three firms would be too small to maintain audit quality and independence, and would call into question the viability of the survivors.

2. The consequences of losing another member of the Big Four to civil or criminal litigation could potentially include the end of the public company audit profession and the takeover of that function by the Government.
 - Government taking over the audit process would lead to qualified professionals leaving the profession.
3. The greatest risk to the Big Four is the omnipresent threat of litigation and regulators must take immediate steps to address it:
 - Because the current pattern of litigation involves huge claims (e.g., one Big Four firm faced a damages claim of \$12.4 billion), firms cannot take the risk of bringing the case to trial.
 - The real problem with litigation is that it increases transaction costs and results in difficult and complex accounting issues being presented to unsophisticated juries.
 - The tempo of litigation against accountants has picked up substantially with each of the Big Four having significant claims in excess of capital.
 - There is widespread agreement that the profession in the United States needs to move away from what is called a rules-based system to a principles-based one, which will lead to greater litigation against auditors.
 - Investors today are suing companies and their auditors for earnings downturns on a regular basis.
 - Audit partners are leaving the profession in fear of losing their personal assets.
4. There is a profound disconnect between investors' expectations and what an audit can actually accomplish, and the profession must reconcile the disconnect.
 - It is impossible for auditors to identify all problems, fraud, or account for all contingencies in the audited financial statements.
 - Although auditors convey their limitations to audit committees and boards, they fail to communicate to the public thereby resulting in the expectation gap.
5. The Big Four are unable to obtain a comprehensive catastrophic risk insurance policy, thereby requiring them to self insure.
 - Because of the limitations on obtaining comprehensive insurance, the current LLP legal structure may not provide the Big Four with enough legal protection.

How bad are the litigation claims?

In 1995, Congress passed the *Private Securities Litigation Reform Act of 1995* (the Act). The Act was designed to curb previous abusive securities litigation, and provides requirements for companies and their auditors involved in securities including rules for:

1. Dealing with forward-looking statements including a safe harbor provision
2. Filing complaints for securities fraud including class action claims
3. An approach for quantifying damages under a litigation claim, including determining proportionate liability
4. Mandatory sanction provision, and
5. Specific requirements for outside auditors including procedures designed to provide reasonable assurance of detecting illegal acts that would have a material effect on the financial statements, identify related party transactions, and evaluating going concern.

In April 2016, Cornerstone Research issued two annual reports; one entitled *Accounting Class Action Filings and Settlements- 2015 Review and Analysis*, and the other, *Securities Class Action Settlements, 2015 Review and Analysis*. The reports confirm that a litigious environment exists that represents dire risk to any one of the Big Four accounting firms, or any other firms that audit SEC companies.

Consider the following statistics from the two Cornerstone reports:

- a. Accounting cases represented 38% of all cases filed in 2015, slightly down from 41% in 2014 and up from 28% in 2013.
- b. Those same accounting cases represented 87% of total settlement dollars in 2015 for all cases that were settled in 2015 (up from 85% in 2014).
- c. In 2015, the average settlement for accounting-related cases was higher than for non-accounting cases.

| <u>Accountant's Involvement</u> | <u>Average settlement</u> |
|---------------------------------|---------------------------|
| Involving accounting issues | \$53 million |
| Involving non-accounting issues | 13 million |

- d. Accountants and auditors were named in 35% of the accounting-related cases in 2015, a 50% increase over the average for the ten prior-year average.

The median settlement increased if the accountant was named as a defendant in the lawsuit.

Settlement as % of damages claimed:

| | |
|-------------------------------|------|
| Accountant is named defendant | 3.7% |
|-------------------------------|------|

Accountant is not named as defendant 2.9%

- e. For the four consecutive year, the majority of new accounting cases filed included financial statement restatement and internal control weaknesses.
- f. Cases involving accountants (as compared with non-accounting cases) are:
- Less likely to be dismissed
 - Far more complex
 - Take longer to resolve, and
 - More costly to defend.
- g. GAAP allegations that involve a financial statement restatement and/or accounting irregularity are the highest settlement amounts in relation to shareholder losses.

| Amount as a Percentage of Damages Claim | | | |
|--|---------------------------------|---|---|
| Accounting Issue | Median settlement amount | Median estimated damages-lawsuit | Median settlement amount as % of estimated damages claim |
| Accounting irregularity | \$2.2 million | \$190 million | 1.1% |
| Restatement | 3.0 million | 248 million | 1.2% |
| Writedown | 19.5 million | 864 million | 2.3% |

Cornerstone, *Accounting Class Action Filings and Settlements- 2015 Review and Analysis*, April 2016

Observation: Although the median settlement amount ranged from 1.1% to 2.3% of the median damages filed in the lawsuit, the risk that the accountant will lose the case forces the firm to settle the case. The fact is that most larger, national CPA firms (including the Big 4) self insure a portion of their malpractice insurance. That means that if a case were to go to trial and the firm lost, the firm could be exposed to having to pay \$300 million to \$700 million in damages. Note further that the numbers in the previous table represent median amounts. In 2015, there were suits filed against Big 4 firms that had individual claim amounts in excess of \$2 billion. If the firm were to lose such a case, the firm would not be able to pay out a \$2 billion judgment. Therefore, accounting firms are very motivated to settle cases as they cannot take the risk that they lose the case.

Simply put, if a plaintiff wants to get its highest settlement amount, the plaintiff should name the accountant/auditor as a defendant and make sure the claim is for several billion dollars. In most cases, the accountant has no choice but to settle or run the risk of losing and going out of business.

In fact, not only are settlements higher when the accountant/auditor is named as a defendant, but other factors result in higher settlement amounts.

Settlements are higher when the following factors exist:

- There are high estimated damages
- There is a higher defendant asset size
- There has been a restatement or corresponding SEC action
- ***An accountant is named as a co-defendant***
- An underwriter is named as co-defendant
- There is a corresponding derivative action
- An institution is a lead plaintiff
- There is a restatement of financial statements
- There is a derivative involved in the claim
- There is also an SEC action against the defendant
- A public pension fund is the plaintiff

h. Top cited accounting issues in lawsuits include:

- Estimates
- Overstated assets
- Understated liabilities and expenses
- Revenue recognition

V. The Viability of the Big Four

Since the demise of Arthur Andersen, there have been numerous reports and recommendations issued to address the Big Four and what many consider to be a risky and unhealthy concentration among the Big Four accounting firms.

The Big Four, along with two second-tier firms, issued a report entitled, *Serving Global Capital Markets and the Global Economy*.

The Report is written with a focus on changes to global financial reporting and public company audit procedures that need to adapt to those changes.

Recommendations made by the Report include:

- a. The world's accounting and auditing standards must be harmonized and based on a principles-based system rather than a rules-based one.

- The World's financial transactions are far too complex to account for under a rules-based system.
- If there is a convergence toward one set of Global standards, that set should be very close to those principles-based standards dictated by the International Financial Reporting Standards (IFRS).

b. Auditing standards should be established at the international level in lieu of the PCAOB.

- One set of global auditing standards would provide global markets and other stakeholders the same quality of audits regardless of where they are conducted.

c. There should be one set of global enforcement and governing rules for auditors including those related to independence.

d. Address the expectation gap regarding fraud detection.

- There are inherent limits as to what fraud auditors can reasonably uncover in an audit yet many investors, policy makers and the media believe that the auditor's main function is to detect all fraud. When fraud materializes and the auditor did not find it, the auditors are presumed to be at fault.
- There needs to be a constructive dialogue among investors, other stakeholders, policy makers and auditors as to what can be done to both narrow the expectation gap and enhance fraud detection. Ideas for fraud detection include:
 - 1) Subject all public companies to a forensic audit on a regular basis (e.g., every three or five years) and/or on a random basis.
 - 2) Let shareholders decide the intensity of the fraud detection effort they want their auditors to perform.

e. Enable networks to integrate further to strengthen audit quality.

- The quality of the audit may be enhanced if the Big Four were able to be structured as one single global operation instead of a network of segments of the firm.
- The current environment limits an audit firm ownership in some countries which require all owners or partners of the firm conducting audits in a jurisdiction to be licensed to practice in that jurisdiction.
- Some countries, including the United States, discourage national firms and their partners or members from being part of a single legal enterprise.

f. Address the concentration in the audit profession.

- The global enforcement markets recognize that the loss of another major audit firm would have a significant impact on the capital markets.
- In order for there to be alternatives to the Big Four, the market must lower the risks within the profession so that networks will make the investment needed to serve the very largest of companies.
- Enforcement authorities must focus penalties for any auditor wrongdoing or negligence on those directly implicated in such activities, rather than on the entire firm that employs them.
- There needs to be liability reform that limits audit firms' exposure to liability so that all firms, even smaller ones, would be willing to take on larger company audit assignments.
- The national governments need to relax the non-attest services performance restrictions for auditors so that there is a greater choice of auditors.

g. Change the financial reporting model.

- A new financial reporting model should be driven by the wants of investors and other users of the financial information.
- Securities regulations should be changed so that financial and non-financial information is reported in real-time over the Internet.
- Information should be forward-looking even though it may be historical in fact.
- Non-financial drivers should include disclosure of measures that include customer satisfaction, product or service defects and awards, and employee satisfaction.

h. The audit industry should be permitted to offer consulting and tax advice to their audit clients so that those firms can attract and retain individuals with the necessary skills and talent to service the profession.

Observation: The markets have looked upon the Big Four report with mixed views. Some commentators consider the suggestions to be self-serving that will result in expanded future business for the national firms. Others consider the report to be forward looking and an essential basis for reinventing the accounting profession.

Report of the Advisory Committee on the Auditing Profession to the U. S. Department of the Treasury

Previously, the U.S. Department of Treasury established an Advisory Committee on the Auditing Profession to deal with the various issues facing firms that audit public companies including the condition, sustainability and future of the auditing profession in light of the fact that the Big Four audit 98 percent of all public companies.

A report entitled *Report of the Advisory Committee on the Auditing Profession to the U. S. Department of the Treasury*, was issued by an Advisory Committee, the purpose of which is to provide recommendations to enhance the sustainability of a strong public company auditing profession.

The Report made the following observations which are still relevant today:

- a. Litigation-related expenses are a significant component of auditing firms' cost structures but are not at a level that significantly affects their ability to recruit talent or grow their practices.
- b. Audits of large public companies are concentrated among a limited number of auditing firms and the largest of these firms are not able to use third-party insurance in a cost-effective manner to manage their litigation costs.
- c. The largest U.S. public companies have enormous market capitalization so that if a large cap company were to become insolvent or suffer a significant decline in value, such a market loss would often exceed the total capital of the auditing firm.
- d. Auditing firms often feel pressure to settle mega or catastrophic claims even if they believe they have meritorious defenses due to the risk that a loss could threaten the firm's survival.
- e. Auditing firms are also at risk for other claims against them including criminal indictment that could threaten survival.

The Report recommended the following changes be made, among many others noted with the Report:

1. Large auditing firms should issue audited financial statements to the PCAOB and should have audit committees.
2. There should be a move toward a national professional liability regime for public company auditing firms.
 - Auditing firms that are faced with litigation claims that threaten their survival should have reasonable opportunity to litigate and appeal such matters.
3. Congress should consider the creation of a federally chartered audit firm structure that would include limits on liability for audits of public companies, mandatory public reporting of audited financial statements, and required capitalization levels, among other requirements.

4. Because of the risk of loss of any of the Big Four firms, the PCAOB should monitor auditor conduct that might present a risk to sustainability of any of the Big Four auditing firms.

Observation: From the tone of the Report, it appears that in order for the Big Four to get some form of limited liability protection from claims, those firms will have to provide greater transparency in terms of the firms' operations and profitability. Query whether that is an acceptable tradeoff.

The current risky environment for the Big Four

One report indicates that the six largest auditing firms (the Big 4 plus Grant Thornton and BDO Seidman) are defendants in close to one hundred private actions related to audits of both public and private companies (either shareholder class actions or actions brought by companies or bankruptcy trustees) with damage claims against the auditors in each case in excess of \$100 million.³⁹

- Forty-one of the ninety cases seek damages in excess of \$500 million.
- Twenty-seven cases seek damages in excess of \$1 billion, and
- Seven cases seek damages over \$10 billion.

In looking at the high percentage of claims that exceed \$1 billion, the Big Four are one large lawsuit away from becoming the Big Three, or Big Two. The highly aggressive litigious environment coupled with a lack of liability caps on lawsuits, exposes any one of the Big Four to the risk that a huge litigation claim puts them out of business.

Grant Thornton and others have stated that the current audit market is unsustainable and that new rules must be created to develop greater competition. In its letter, Grant Thornton noted that in the event of the demise of any one of the Big Four, 20 percent of the 7,200 largest businesses in the G20 would be left without an auditor.⁴⁰

In general, it is unlikely that any one of the Big Four could sustain a litigation claim in the \$1-2 billion range.

The latest example of a single lawsuit that can bring down one of the Big Four is the series of lawsuits that are pending against several of the Big Four and other CPA firms involved in the Madoff scandal. Previously in this course, the auditor discussed the litigation that continues against many of the auditors of the feeder funds that invested in Madoff's funds.

In general, each of these lawsuits were filed by feeder funds that were audited by the Big Four and that had money invested with Madoff.

³⁹ Treasury Advisory Committee on the Auditing Profession, Final Report

⁴⁰ Grant Thornton letter, as published in accountancyage.com.

For example:

- KPMG was sued for \$3.3 billion by Tremont Group, a feeder fund invested with Madoff.
- PWC's United States, Bermuda, and U.K. are being sued by parties in connection with Fairfield Sentry, a feeder fund that had \$7.2 billion of assets invested with Madoff.
- Ernst & Young was sued in Luxembourg by a group of investors involved in the LuxAlpha Fund that once had \$1.4 billion invested with Madoff.

At the heart of most of these lawsuits is whether the auditor for the feeder fund had a responsibility to audit and verify the existence of the fund's assets invested with Madoff. None of the Big Four were Madoff's auditors.

In the PWC case, the plaintiffs alleged that PWC did meet with Madoff and accepted his assertions about the existence of funds without verifying the existence of the funds. PWC alleges that it had no responsibility to audit the underlying fund assets held by Madoff given the fact that PWC was not Madoff's auditor.

The plaintiffs also observed that PWC did nothing to investigate the credentials of the small audit firm, Friehling & Horowitz, that audited the Madoff funds.

Given the size of the lawsuits against the Big Four in the Madoff scandal, most, if not all of them, have been settled, as the Big Four cannot take the risk of losing any one of these multi-billion dollar claims.

The allegations made that the feeder fund auditor must look through and audit the underlying assets of the core fund (Madoff in this case) could have chilling effects on how investment funds get audited. Many auditors of feeder funds may be reluctant to audit the feeder fund unless they are also auditing the core investment fund.

How big would a claim against a Big Four firm have to be to put it out of business?

Because the Big Four firms self insure a large portion of their settlements, any one of the Big Four is at risk of being forced out of business due to one mega-claim coming to fruition.

The question is how large must a claim be to yield the lethal blow to a Big Four firm?

Recently, James Peterson, former inside counsel for Arthur Anderson, calculated how large a legal judgement, fine or settlement would have to be to cause a Big-Four firm failure.⁴¹

Peterson's model is based on an earlier report by consulting firm London Economics, which modeled the maximum threshold of a claim against any one of the Big Four-UK partnerships.

⁴¹ *The Financial Fragility of the Big Four Accounting Firms- Updating the "Tipping Point"* James Peterson

The model used is based on the following general assumptions:

- a. If there is a large litigation result against a Big Four firm, that firm's viability would be exposed to the combined effects of a financial crisis environment, reputational pressure, and the hostile publicity from the adverse litigation result.
- b. In a crisis environment, if there is a per-partner profit reduction of 15% to 20% that extends over three to four years, a critical number of partners would defect placing the firm in a death spiral.
- c. U.S. practices of any one of the Big Four could sustain a claim ranging from a high of \$3.6 billion to as low as \$900 million. Any claim or series of claims in excess of this range would expose a Big Four firm to the risk of failure.

VI. The Effect of Enron- 15 Years Later

2017 marks the 15-year anniversary of the demise of Enron and the issuance of the *Powers Report* that provided a detailed account of the reasons for Enron's demise.

Depending on who you speak with, Enron may go down in history as the single event that had the most impact on changing the accounting profession.

Now, more than a decade later, the question is whether Enron helped the profession, or did nothing more than create unnecessary administrative oversight and burden.

Let's look at some of the facts:

1. The demise of Enron resulted in a sizeable corporate economic failure that culminated in millions of dollars of lost investments, the unemployment of thousands of Enron employees, along with the dire loss of employee retirement funds that were invested in Enron stock.
2. Top Enron executives went to prison including Andrew Fastow (CFO), Jeffrey Skilling (CEO) and Kenneth Lay (Chairman, who died before serving his prison sentence).
3. Arthur Anderson was charged with criminal obstruction of justice and went out of business, changing the Big Five to the Big Four [Anderson's obstruction charges were overturned in 2005].
4. Sarbanes-Oxley Act was passed in July 2002 and made sweeping changes to the accounting profession:
 - a. Auditors were no longer permitted to perform certain nonattest and consulting services for their audit clients.
 - b. Mandatory audit partner (not firm) rotation every five years was implemented.

- c. A new Public Company Accounting Oversight Board (PCAOB) was created to promulgate rules for public company auditors.
 - The accounting profession lost its right to self-regulation when the AICPA's Auditing Standards Board (ASB) lost the authority to issue auditing standards for public company auditors.
 - PCAOB was required to conduct regular peer reviews and inspections of public company auditors.
5. Audit committee and board rule changes:
 - a. New standards were created for audit committees, requiring that companies assign at least one "financial expert" to the audit committee, among other changes.
 - b. New conflict of interest rules were created to ensure that board members could not profit from other transactions with the company for which the board served.
 - c. The audit committee was put in charge of hiring the auditor and negotiating the audit fees, taking away that activity from management.
6. A new whistle-blower program was created.
7. Section 404 of Sarbanes Oxley required companies to assess their internal controls and have their accountants report on such controls.
8. Section 302 of Sarbanes Oxley required the CEO and CFO to sign off on company financial statements.
9. Sarbanes Oxley introduced a series of criminal penalties for financial fraud, with a maximum prison term of 20 years.
10. Sarbanes introduced a Section 304 clawback provision, requiring a CEO or CFO to reimburse a company for any bonus or other incentive-based or equity-based compensation received during the 12-month period following a restatement due to a material noncompliance.
11. FASB issued an entire series of new standards to deal with better transparency and off-balance sheet transactions:
12. Sarbanes required the SEC to study whether a principles-based accounting system should be used for U.S. GAAP.

Sarbanes Oxley push to record and disclose off-balance sheet transactions

Perhaps no section of Sarbanes Oxley has had a more significant effect on all CPAs and their companies than Section 401 of Sarbanes Oxley.

Section 401(c) of Sarbanes Oxley required the SEC to complete a study of off-balance sheet transactions and related disclosures to determine:

- a. The extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities, including an estimated amount of off-balance sheet transactions, and
- b. Whether GAAP results in financial statements reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.

In 2005, the SEC performed an exhaustive study of off-balance sheet transactions that resulted in the issuance of their report entitled: *Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.*

That report, coupled with other pressures on the FASB, has resulted in the FASB taking aggressive action to issue various pronouncements that have resulted, or will result, in transactions being recorded on the balance sheet, even though not previously recorded.

Following is a list of pronouncements that the FASB has issued since the passage of Sarbanes-Oxley Act, and several pending projects:

| Some Key FASB Pronouncements Post-Sarbanes Oxley Act | | |
|---|--|--|
| Pronouncement Issue | What it Does | Estimated Increase in Liabilities for SEC Companies |
| ISSUED | | |
| FIN 45: Guarantor's Accounting and Disclosure Requirements for Guarantees | Requires the recognition of liabilities for obligations undertaken upon issuing certain guarantees, as well as other disclosures | \$125 billion |
| FIN 46R: Consolidation of Variable Interest Entities | Requires consolidation of certain variable interest entities as opposed to an approach based on control by ownership or legal authority | \$444 billion |
| Share-Based Payment, SFAS No. 123(R) | Requires a fair-value based method of accounting for stock options and other equity instruments used to purchase goods and services, including employee services, eliminating the previous accounting guidance that allowed compensation paid in a particular form to go unreported in the financial statements. (2) | Not available |
| FASB No. 132: Disclosures About Pensions and Other Postretirement Plan Assets | Expands employers' disclosures about pension plans and other post-retirement benefit plans | NA |
| FASB No. 150: Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equities | Requires a company to classify and measure certain financial instruments with characteristics of both liabilities and equity | Not available |
| FASB No. 158: Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans | Requires an entity to record the funded status of a defined benefit pension plan on its balance sheet | \$400 to \$500 billion |
| ASU 2013-04: Liabilities (Topic 405): Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date | Provides rules for companies to measure and record joint and several liability arrangements. | Not available |

| | | |
|---------------------|---|-----------------|
| ASU 2013-03: Leases | Records most lease assets and liabilities | \$1.25 trillion |
|---------------------|---|-----------------|

| | | |
|---|---|---------------|
| PENDING | | |
| Other Contractual Obligations, Including Purchase Commitments | Goal to record various contractual commitments as liabilities instead of merely disclosing them | \$725 billion |
| Fair Value Accounting | Goal to record all financial assets and liabilities at fair value | TBD |

1. Per the SEC Report, the estimate of total exposure is about \$46 trillion, of which only \$125 billion is recorded as liabilities.
2. The FASB's issuance of FASB No. 123R was not directly influenced by Sarbanes Oxley or the SEC.

Note: The estimated liabilities in this chart reflect only public companies as published by the SEC. There are trillions of dollars more in liabilities that have or will be recorded by non-public companies, the exact amount of which is not available.

In looking in the list, trillions of dollars of liabilities have already been brought onto balances sheets with an additional couple of trillion more, once lease changes are made.

Has Enron resulted in any good changes to the accounting profession?

The primary impact of Enron was the passage of Sarbanes-Oxley. Although many commentators believe that Sarbanes has placed undue procedures and cost on companies, many third parties believe that Sarbanes has had some positive results:

The good changes:

- Now that Section 404 compliance has been implemented by SEC companies, many of those same companies believe that it has resulted in companies cleaning up glaring weaknesses in internal control.

Note: Although in the early years, the cost to implement Section 404 increased total audit costs by 40 to 60 percent, now most companies have noted that those costs have come down considerably.

- Financial statement restatements have come down in 2010 through 2015, from a peak in 2005.
- Auditors are now hired by the audit committee and not by company management.

- There is now a considerable separation between non-attest consulting and audit services within the same firms.

Now the bad:

- FASB standards have expanded considerably, placing a huge burden on all companies, particularly non-public companies, such as consolidation of variable interest entities (VIEs) and pension rules.
- Sarbanes changes have trickled down to expansive issuance of auditing standards by the Auditing Standards Board, applicable to non-public company auditors.
- Despite all the additional work required by Sarbanes, it failed to prevent the financial crisis during 2008 and 2009.
- The SEC has been overzealous in applying the clawback provisions of Section 304 of Sarbanes to executives, including those that were not responsible for the underlying restatement.
- Detection of fraud has not improved in the post-Enron environment.
- The Justice Department filing criminal charges against Arthur Anderson created the Big Four and a very tight pool of large audit firms capable of auditing large, multi-national companies.

VII. Going Concern Issues

For years, the rules for going concern have been found in auditing literature within AU-C Section 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), which requires an auditor to assess whether an entity has the ability to continue as a going concern for a reasonable period of time (usually one year from the balance sheet date.) Because going concern is a GAAP issue, it belongs within accounting literature, in addition to auditing standards.

Background- Going Concern in Auditing Literature

In December 2016, Audit Analytics issued a report in which it performed a 16-year study of going-concern opinions.

The report, which samples financial statements through 2015, identifies the following trends:

1. 2015 going-concern report modifications were at the lowest level over a 16-year period.

| <u>Year</u> | <u>Going-concern opinions</u> |
|-------------|-------------------------------|
| 2015 | 2,016 |
| 2014 | 2,230 |
| 2013 | 2,425 |
| 2012 | 2,570 |
| 2011 | 2,671 |
| 2010 | 2,988 |
| 2009 | 3,103 |
| 2008 | 3,354 |

Source: Audit Analytics

- 15.1% of auditor opinions filed in 2015 contained a going-concern report modification. [The highest percentage was 21.1% in 2008, and lowest was 14.2% in 2000.]
- Going-concern report modifications peaked at 3,352 in 2008 and dropped to 2,016 in 2015.

What percentage of companies recover from a going-concern report modification?

Interestingly, only a small percentage (ranging from 5 to 9%) of companies that had going concern report modifications rebounded with a clean opinion in the subsequent year.

The following table shows the details:

| Number of Clean Opinions in Subsequent Year to Going-Concern Report Modification | | | |
|---|------------------------------------|--|--------------------------------------|
| <u>Year</u> | <u># going concerns prior year</u> | <u># clean opinions current year, going concern prior year</u> | <u>% recovery in subsequent year</u> |
| 2015 | 2,230 | 123 | 5.5% |
| 2014 | 2,425 | 200 | 8.3% |
| 2013 | 2,570 | 188 | 7.3% |
| 2012 | 2,671 | 144 | 5.4% |
| 2011 | 2,988 | 208 | 7.0% |
| 2010 | 3,103 | 276 | 8.9% |
| 2009 | 3,354 | 265 | 7.9% |
| 2008 | 3,309 | 200 | 6.0% |
| 2007 | 2,878 | 253 | 8.8% |

Observation: The previous table illustrates a key point with respect to going-concern report modifications. If such a report modification is made, it can be the "kiss of death" for a company in the subsequent years. A very low percentage of companies subsequently survive a going-concern report modification.

Does a going-concern report modification protect the auditor?

In 2012, Steven E. Kaplan and David D. Williams published the results of a study in a paper entitled: "*Do going-concern audit reports protect auditors from litigation? A simultaneous equations approach.*" Their study was conducted to look at the issue of whether an auditor of a financially stressed entity reduces litigation risk by issuing a going-concern report modification.

The study reached the following conclusions:

- a. Auditors make going-concern reporting decisions strategically, considering the litigation risk of their financially stressed clients.
- b. Auditors use going-concern reporting as a preemptive action in response to elevated levels of litigation risk.
- c. Issuing a going-concern report is associated with a lower likelihood of being named in a class action lawsuit. Investors consider the auditor's report when making litigation decisions for their financially stressed investments.
- d. Going-concern reports deter investors from filing class action lawsuits against auditors.

Note: When investors see a going-concern report for financially stressed companies, they are apparently less likely to blame the auditor for their investment losses.

Issuing a going-concern report offers the auditor protection against claims of negligence due to reporting, but not other claims of auditor negligence. For example, a going-concern report is unlikely to deter investors from naming the auditor in a lawsuit in situations involving allegations of auditor negligence for fraudulent financial statements.

- e. Issuing a going-concern audit report increases the likelihood of management-initiated auditor switches.

Is the language in the auditor's going-concern report modification effective?

Since the issuance of AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (formerly SAS No. 59), the going-concern report modification has come under scrutiny. In the early 2000s, criticism was placed on the auditing profession that too many companies that filed bankruptcy did not have a going-concern report modification issued prior to filing bankruptcy.

The language found in AU-C 570 is as follows:

Emphasis of Matter Regarding Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company's has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to that matter.

Financial statement users continue to criticize the going concern report modification language for several reasons.⁴²

1. The language used in AU-C 570 (formerly SAS 59) is vague, allowing for broad interpretation.
 - The terms “*substantial doubt*” and “*for a reasonable period of time*” are not clearly understood by third party users.
2. AU-C 570 places the responsibility for evaluating whether there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time squarely on the auditor’s shoulders and not management.
 - The auditor is required to assess the effectiveness of management’s plans for mitigating the going concern issue even though the auditor is not responsible for predicting future conditions or events.
 - Management is responsible for predicting future conditions or events, but management is not responsible for the going concern issue.
3. Investors and bankers complain that the current language found in the going-concern report modification causes alarm to the market and adversely affects the auditor:
 - The language in the going concern report modification creates bad financial distress and sends investors and bankers quickly running away.
4. The language in both the report and disclosure adversely affects the auditor.
 - The language leaves the auditor with either:
 - 1) a client with a recovery plan destined for failure, or

⁴² *Going Concern: Where Is It Going?* Clemense Ehoff Jr., Central Washington University, USA Ahli Gray, Keiser University, USA, 2014

- 2) a client who is looking for another auditor willing to avert the going concern disclosure, commonly known as opinion shopping.

In either case, the auditor is faced with the risk of losing revenue if he or she inserts a going concern disclosure.

Note: AU-C 570 (formerly SAS No. 59) was supposed to be a warning sign for investors. Instead, it is often perceived as a “death sentence” for companies. The FASB's project on going concern requires management to evaluate going concern, thereby shifting some of the burden of evaluating going concern from the auditor to management (see further discussion further on in this section.)

Going Concern- GAAP versus Auditing Standards

FASB issues ASU 2014-15

In August 2014, the FASB issued ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*.

ASC 205-40 provides guidance about management’s responsibility to evaluate an entity’s ability to continue as a going concern and to provide related disclosures. Previously, no such guidance existed in GAAP.

ASU 2014-15 is effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted.

The objective of ASU 2014-15 is to provide guidance for evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern and about related footnote disclosures.

FASB ASC 205-40 does the following:

- a. Requires management to make an evaluation of going concern every reporting period, including interim periods
- b. Defines the term *substantial doubt about an entity’s ability to continue as a going concern* (substantial doubt) as follows:

"Substantial doubt about an entity’s ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable)."

Note: The term *probable* is used consistently with its use in Topic 450 on contingencies.

- c. Provides that management should consider the mitigating effect of management's plans only to the extent it is probable the plans will be effectively implemented and mitigate the conditions or events giving rise to substantial doubt
- d. Requires certain disclosures when substantial doubt is alleviated as a result of consideration of management's plans
- e. Requires an explicit statement in the notes that there is substantial doubt and other disclosures when substantial doubt is not alleviated, and
- f. Requires an evaluation for a period of one year after the date that the financial are issued (or available to be issued if a nonpublic entity).

After the issuance of ASU 2014-15, there were certain inconsistencies between the GAAP and auditing rules for dealing with going concern.

In particular, the one year period of time for evaluating going concern was different as follows:

- a. AU-C 570 uses a reasonable period of time as the period for which an auditor should evaluate going concern. Generally, that period is one-year period from the balance sheet date
- b. ASU 2014-015 uses a one-year period from the date the financial statements are issued or available to be issued.

In response, the Auditing Standards Board (ASB) issued an auditing interpretation in January 2015.

AU-C Section 9570: Auditing Interpretation: The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern: Auditing Interpretations of AU-C 570

In January 2015, the Auditing Standards Board (ASB) issued an interpretation to address conflicting issues related to GAAP's recently issues, ASU 2014-15, *Presentation of Financial Statements- Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern* and, going concern rules found in AU-C 570.

The purpose of this interpretation is to clarify how AU-C 570's requirements for an auditor addressing going concern interrelates with the new GAAP rules found in ASU 2014-15.

1. Definition of Substantial Doubt About an Entity's Ability to Continue as a Going Concern

Question: AU-C section 570 refers to the term "substantial doubt about an entity's ability to continue as a going concern" but does not define it. For example, AU-C section 570 requires the

auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a *reasonable period of time*.

In applying AU-C section 570, how should an auditor apply the term substantial doubt about an entity's ability to continue as a going concern when the term is defined in the applicable financial reporting framework?

Interpretation: AU-C section 700, *Forming an Opinion and Reporting on Financial Statements*, requires the auditor to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. As a result, when the applicable financial reporting framework includes a definition of substantial doubt about an entity's ability to continue as a going concern, that definition would be used by the auditor when applying AU-C section 570.

For example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, the definition of substantial doubt about an entity's ability to continue as a going concern set out in FASB ASC 205-40 would be used by the auditor.

2. *Definition of Reasonable Period of Time*

Question: AU-C section 570 requires the auditor to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a *reasonable period of time*.

AU-C section 570 defines reasonable period of time as

“a period of time not to exceed one year beyond the date of the financial statements being audited.”

How should an auditor apply this definition when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements?

Interpretation: As noted in Auditing Interpretation No. 1, *“Definition of Substantial Doubt About an Entity's Ability to Continue as a Going Concern,”* the auditor is required to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

As a result, when the applicable financial reporting framework requires management to evaluate whether there are conditions and events that raise substantial doubt for a period of time greater than one year from the date of the financial statements, the auditor's assessment of management's *going concern evaluation would be for the same period of time as required by the applicable financial reporting framework* in forming an opinion on whether the financial statements are presented fairly, in all material respects, and determining whether an emphasis-of-matter paragraph is required. .

For example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, the auditor's assessment of management's going concern evaluation would need to be for the same period of time as required by FASB ASC 205-40 (that is, one year after the date that the financial statements are issued or available to be issued) in forming an opinion on whether the financial statements are presented fairly, in all material respects, and determining whether an emphasis-of-matter paragraph is required.

3. *Interim Financial Information*

Question: AU-C section 930, *Interim Financial Information*, states that the objective of the auditor when performing an engagement to review interim financial information is to obtain a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework through performing limited procedures.

AU-C section 930 addresses the auditor's responsibility about when to make an inquiry concerning an entity's ability to continue as a going concern.

What are the auditor's responsibilities when the applicable financial reporting framework contains explicit requirements concerning management's responsibilities related to evaluating the entity's ability to continue as a going concern for interim financial information (for example, if an entity is required to comply with, or has elected to adopt, FASB ASC 205-40 early, management is required to comply with FASB ASC 205-40 when preparing interim financial information, including, when applicable, providing disclosures if substantial doubt about an entity's ability to continue as a going concern exists or has been alleviated)?

Interpretation: In accordance with AU-C section 930, if (a) conditions or events that may indicate substantial doubt about an entity's ability to continue as a going concern existed at the date of prior period financial statements, regardless of whether the substantial doubt was alleviated by the auditor's consideration of management's plans, or (b) in the course of performing review procedures on the current period interim financial information, the auditor becomes aware of conditions or events that might be indicative of the entity's possible inability to continue as a going concern, the auditor is required to

- a. inquire of management about its plans for dealing with the adverse effects of the conditions and events, and
- b. consider the adequacy of the disclosure about such matters in the interim financial information.

The consideration of the adequacy of management's disclosures about the entity's ability to continue as a going concern in the interim financial information includes a consideration of whether the entity's financial statements are presented in accordance with the applicable financial reporting framework. As a result, when the applicable financial reporting framework includes explicit requirements for management to evaluate the entity's ability to continue as a going concern in preparing interim financial information, the auditor is required to perform interim review

procedures related to management's evaluation of the entity's ability to continue as a going concern and the adequacy of the related disclosures in the interim financial information.

4. Consideration of Financial Statements Effects

Question: AU-C section 570 establishes requirements for the auditor to consider the possible effects on the financial statements and the adequacy of the related disclosure in substantial doubt has been alleviated after consideration of management's plans. In addition, in assessing the adequacy of the disclosures, the related application guidance in AU-C section 570 provides examples of matters that management might disclose in the financial statements.

How should an auditor apply this guidance when the applicable financial reporting framework contains disclosure requirements related to management's going concern evaluation? .

Interpretation: As noted in Auditing Interpretation No. 1, the auditor is required to form an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

As a result, when the applicable financial reporting framework provides disclosure requirements related to management's evaluation of substantial doubt, the auditor's assessment of the financial statement effects under AU-C section 570 would be based on the disclosure requirements of the applicable financial reporting framework.

Observation: The auditing interpretation essentially states that in evaluating going concern, *an auditor should follow the same rules found in GAAP with respect to the period of time to which the evaluation should be applied.* That period of time is *one year from the date the financial statements are issued or available to be issued (if a nonpublic entity).* Thus, the period of time that has been used for auditors previously (one year from the balance sheet date) is extended to be one year from the date the financial statements are either issued (public entities) or available to be issued (nonpublic entities). This change adds a few months to the going concern assessment period for an auditor. It also means that it is important that the auditor conclude his or her audit and ensure that the financial statements are issued so that the one-year period commences. The later the financial statements are issued, the later the one- year going-concern period is extended.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect. To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow.

1. In “*Auditing: A Profession at Risk*,” which of the following recommendations was made by Chamber of Commerce to save the audit profession:
 - a. Expand accounting rules and move toward a principles-based system
 - b. Better define auditor procedures and responsibility for fraud detection
 - c. Eliminate the use of an alternative dispute resolution system
 - d. Expand the rules for Section 404 of Sarbanes-Oxley
2. According to the report, *The Future of the Accounting Profession: Auditor Concentration*, which of the following is not a factor contributing to the threat of litigation against Big Four auditors:
 - a. Firms cannot take the risk of bringing a case to trial
 - b. The increase in transaction costs with litigation
 - c. Audit fees are not commensurate with the risk
 - d. Investors are suing companies and their auditors for earnings downturns
3. Cornerstone Research reported that settlements are higher when which factor exists:
 - a. Lower defendant asset size
 - b. There has been no restatement
 - c. A corresponding derivative action has been taken
 - d. There is no co-defendant
4. Which recommendation was made in the Big Four report, *Serving Global Capital Markets and the Global Economy*:
 - a. The PCAOB should establish auditing standards
 - b. International standards should determine the effort level that auditors should expend in detecting fraud
 - c. The Big Four should be able to work together further to strengthen audit quality
 - d. The world’s accounting and auditing standards should be rules-based
5. Emily Melio is a CPA and is considering issuing a going concern report modification on Company X, an entity she is auditing. Which of the following is correct.
 - a. If X following the typical trend, X should recover and have a clean opinion in the year following the going concern report modification
 - b. X is not likely to have a clean opinion in the following year
 - c. There is no correlation between the year of a going concern opinion and the subsequent year

- d. X will be out of business within one year because that is precisely what a going concern opinion states will happen

SUGGESTED SOLUTIONS

1. In “Auditing: A Profession at Risk,” which of the following recommendations was made by Chamber of Commerce to save the audit profession:
 - a. Incorrect. The Chamber of Commerce made a recommendation that the FASB needs to address the problem of infinite complication in accounting rules, and not expansion of accounting rules. Nothing was mentioned about a principles-based system.
 - b. Correct. The Chamber of Commerce did recommend that, to help the profession become insurable, auditor procedures and responsibility for fraud detection should be better defined and the auditor’s responsibility to it should be limited.**
 - c. Incorrect. The Chamber of Commerce recommended that an alternative dispute resolution system should be created for dispute about audits to avoid litigation. Eliminating the resolution system was not mentioned making the answer incorrect.
 - d. Incorrect. The Chamber of Commerce recommended that PCAOB standards be clarified and that Section 404 of Sarbanes-Oxley needed better explanation to save auditors from “overauditing” due to vague, nebulous guidance. Nothing was mentioned about expanding the rules for Section 404, making the answer incorrect.

2. According to the report, *The Future of the Accounting Profession: Auditor Concentration*, which of the following is not a factor contributing to the threat of litigation against Big Four auditors:
 - a. Incorrect. One major problem with the Big Four going to trial is that they cannot take the risk that they lose, resulting in the demise of the firm. Thus the answer is correct.
 - b. Incorrect. Because of the complexity of audit evidence, the costs of defending a lawsuit are significant, forcing auditors to settle, making the answer correct.
 - c. Correct. There is no reference in the report to audit fees not being commensurate with the risk. Thus, the answer is not a factor.**
 - d. Incorrect. The report notes that investors are suing companies and their auditors for earnings downturns on a regular basis, thereby exposing auditors to extensive litigation risk. This answer represents one of the identified factors.

3. Cornerstone Research reported that settlements are higher when which factor exists:
 - a. Incorrect. The report concluded that settlements are higher when the defendant asset size is higher, not lower. With higher assets, there is greater risk of loss thereby motivating settlement at a higher amount paid by the defendant.
 - b. Incorrect. The report concluded that settlements are higher when there has been a restatement, and a corresponding SEC action. The reason appears to be because with the restatement, there is a claim that can be made by plaintiffs against the defendants.
 - c. Correct. The report concluded that settlements are higher when there is a corresponding derivative action, which yields a higher overall risk.**
 - d. Incorrect. The report concluded that settlements are higher when there is either an accountant or an underwriter named as a co-defendant. The reason is because accountants and underwriters are more likely to quickly settle the case due to the risk of losing in court. The report does not reference that the settlements are higher when there is no co-defendant, making the answer incorrect.

4. Which recommendation was made in the Big Four report, *Serving Global Capital Markets and the Global Economy*:
 - a. Incorrect. One of the Big Four's recommendations was that auditing standards should be established at the international level in lieu of the PCAOB.
 - b. Incorrect. One of the Big Four's ideas for fraud detection was to let shareholders (not international standards) decide the intensity of the fraud detection effort they want their auditors to perform.
 - c. **Correct. One of the Big Four's recommendations was that networks of auditors should be established to further to strengthen audit quality. The report suggests that the current environment limits an audit firm's ownership in some countries which requires all owners or partners of the firm conducting audits in a jurisdiction to be licensed to practice in that jurisdiction.**
 - d. Incorrect. One of the Big Four's recommendations was that the world's accounting and auditing standards must be harmonized and based on a principles-based system rather than a rules-based one.

5. Emily Melio is a CPA and is considering issuing a going concern report modification on Company X, an entity she is auditing. Which of the following is correct.
 - a. Incorrect. History suggests that X will not likely recover and have a clean opinion in the year following the going concern report modification. Only a small percentage of companies recover the next year with a clean opinion.
 - b. **Correct. Only about 5% to 9% have a clean opinion in the subsequent year making the answer correct.**
 - c. Incorrect. According to one study, there is a correlation between the year of a going concern opinion and the subsequent year in that only a small percentage of entities that have going concern opinions recover in the next year with a clean opinion.
 - d. Incorrect. The opinion merely states there is substantial doubt that an entity will continue as a going concern. That language is certainly not absolute and does not state that the entity will be out of business within one year.

Glossary

Audit of ICFR: An audit of the design and operating effectiveness of an entity's ICFR.

Brainstorming: A method of shared problem solving in which all members of a group spontaneously contribute ideas.

Control objective: The aim or purpose of specified controls. Control objectives address the risks that the controls are intended to mitigate.

Criteria: The benchmarks used to measure or evaluate the subject matter.

Deficiency in internal control: The design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

Detective control: A control that has the objective of detecting and correcting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

Emphasis-of-matter paragraph: A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit.

Group: All the components whose financial information is included in the group financial statements. A group always has more than one component.

Group engagement partner: The partner or other person in the firm who is responsible for the group audit engagement and its performance and for the auditor's report on the group financial statements that is issued on behalf of the firm.

Group engagement team: Partners, including the group engagement partner, and staff who establish the overall group audit strategy, communicate with component auditors, perform work on the consolidation process, and evaluate the conclusions drawn from the audit evidence as the basis for forming an opinion on the group financial statements.

Group financial statements: Financial statements that include the financial information of more than one component.

Internal control over financial reporting (ICFR): A process effected by those charge with governance, management, and other personnel, designed to provide reasonable assurance

regarding the preparation of reliable financial statements in accordance with the applicable financial reporting framework.

Management's assessment about ICFR: Management's conclusion about the effectiveness of the entity's ICFR, based on suitable and available criteria.

Material weakness: A deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Modified opinion: A qualified opinion, an adverse opinion, or a disclaimer of opinion.

Money laundering: To move illegally acquired cash through financial systems so that it appears to be legally acquired.

Noncompliance: Acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

Other-matter paragraph: A paragraph included in the auditor's report that is required by GAAS, or is included at the auditor's discretion, and that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report.

Pervasive: A term used in the context of misstatements to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit-evidence.

Preconditions for an audit: The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, when appropriate, those charged with governance, to the premise on which an audit is conducted.

Preventive control: A control that has the objective of preventing errors or fraud that could result in a misstatement of the financial statements.

Privity standard: Accountant's liability is limited to those third parties with whom the accountant has a contractual relationship.

Professional skepticism: An open-minded attitude that presumes that parties are neither totally honest nor totally dishonest.

Public Company Accounting Oversight Board (PCAOB): A regulatory body created by the Sarbanes-Oxley Act of 2002, which regulates audits of SEC registrants, and operates under the U.S. Securities and Exchange Commission.

Rainy day fund: A hidden reserve that can be used to adjust quarterly earnings.

Recurring audit: An audit engagement for an existing audit client for whom the auditor performed the preceding audit.

Responsible party: The party(ies) responsible for the subject matter. If the nature of the subject matter is such that no such party exists, a party who has a reasonable basis for making a written assertion about the subject matter may be deemed to be the responsible party.

Sarbanes-Oxley Act: The Act signed into law that became effective in 2002. The Act contains sweeping reforms for issuers of publicly traded securities, corporate board members, and lawyers. It adopts tough new provisions intended to deter and punish corporate and accounting fraud and corruption, threatening severe penalties for wrongdoers, and protecting the interests of workers and shareholders.

Significant component: A component identified by the group engagement team (i) that is of individual financial significance to the group, or (ii) that, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Significant deficiency: A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

Special purpose financial statements: Financial statements prepared in accordance with a special purpose framework.

Special purpose framework: A financial reporting framework other than GAAP that is one of the following bases of accounting: cash basis, tax basis, regulatory basis, or contractual basis.

Specified party: The intended user(s) to whom use of the written practitioner's report is limited.

Spring-loading: The practice in which an entity acquiring another entity may try to manipulate the financial performance of the target entity during the pre-acquisition period.

FINAL EXAM

1. A factor to consider in evaluating going concern consists of which of the following:
 - a. Continued earnings and profitability during a negative downturn
 - b. Strong working capital trends
 - c. Reliance on external financing to generate cash rather than relying on earnings
 - d. Financial difficulties such as loan defaults or denial of trade credit from suppliers

2. Which of the following is an auditing procedure with respect to receivables:
 - a. Investigate standard payment terms given to customers
 - b. Review the industry in which the customers operate
 - c. Test the realization of receivables
 - d. Perform a three-year look back test of sales volume posted to accounts receivable

3. Specific auditing procedures to determine if inventories are properly valued include which one of the following:
 - a. Previous sales demand in prior years
 - b. The change in the mix of inventories between raw materials, work in process, and finished goods
 - c. The quantity of high-value inventory items at year end
 - d. Anticipated technological changes that could affect the value of inventories

4. Under existing ASC 320, *Debt and Equity Securities* (formerly FASB No. 115), how should trading securities be accounted for:
 - a. At cost
 - b. At fair value with the unrealized gain or loss on the income statement
 - c. At current value with the unrealized gain or loss presented in stockholders' equity
 - d. At lower of cost or market

5. Categories of debt securities included under existing ASC 320 (formerly FASB No. 115) include which one of the following:
 - a. Investments in closely held businesses
 - b. Debt securities held-to-maturity
 - c. Investments held using the equity method
 - d. Investments of more than 50% of the voting shares of common stock

6. What continues to head the list of areas subject to fraudulent financial reporting:
 - a. Inventory valuation
 - b. Revenue recognition
 - c. Understating payables
 - d. Overstating prepaid items

7. An example of a spring-loading tactic that auditors should be aware of is _____.
 - a. Writing up investments
 - b. Lowering the reserve for inventory obsolescence
 - c. Accelerating the purchased company's payment of payables
 - d. Inflating a reserve for inventory obsolescence

8. What differentiates fraud from an error:
 - a. Intent
 - b. Risk
 - c. Degree of loss
 - d. Type of loss incurred

9. The three conditions of the fraud triangle include all of the following except:
 - a. Lifestyle and standard of living
 - b. Incentive and pressure
 - c. Opportunity
 - d. Rationalization or attitude

10. Common types of financial statement fraud noted by the FBI include all of the following except:
 - a. Phony sales
 - b. Identity theft
 - c. Parked inventory sales
 - d. Channel stuffing

11. Which of the following is an example of a misappropriation of assets:
 - a. Overstating revenue
 - b. Embezzling receipts
 - c. Understating an allowance for uncollectible accounts
 - d. Bribing government officials

12. In comparing the different types of fraud, which of the following has the highest ease of concealing the identity of the fraudster:
 - a. Phony vendors
 - b. Register disbursement
 - c. Expense reimbursement
 - d. Check tampering

13. Which of the following is not an element of an auditor having professional skepticism:
- Having a questioning mind and performing a critical assessment of all audit evidence received
 - Possessing a “show me” mindset that recognizes the distinct possibility that a material misstatement due to fraud could be present
 - Ensuring that all statements made by a client are included in a management representation letter
 - Probing evidence more thoroughly and critically
14. AU-C 240 (formerly SAS No. 99) requires that an auditor perform three additional procedures to deal with the risk of management override of internal controls. Which of the following is one of those additional procedures:
- Perform a physical observation of inventories
 - Confirm trade receivables
 - Conduct a brainstorming session
 - Evaluate the business rationale for significant unusual transactions
15. One of the key elements emphasized in AU-C 240 (formerly SAS No. 99) is for an auditor to have heightened professional skepticism in conducting an audit. The AICPA’s *Audit Risk Alert* identifies a list of “circumstances and observations” that should catch the attention of the auditor. That list includes which one of the following:
- A company that has a culture of humility
 - A strong audit committee and board governance
 - An overly loyal management team
 - An overly centralized control over the financial reporting process
16. An example of a missed audit procedure that enhances the risk that fraud might not be detected is which one of the following:
- Confirming information through independent corroborating evidence of management representations
 - Accepting confirmations sent directly to the auditor
 - Failure to observe inventories
 - Failure to confirm unusual transactions with third parties
17. SAB No. 101, *Revenue Recognition in Financial Statements*, offers four criteria that need to be met in order to recognize revenue. The four criteria include all of the following except:
- There is persuasive evidence that an arrangement exists
 - A delivery of goods has occurred or services have been rendered
 - There is a right to return the goods by the buyer
 - Collectibility of the sale or service is reasonably assured

18. Under ASC 605-15-25, *Revenue Recognition-Products- Recognition* (formerly FASB No. 48), if an entity sells its product but gives the buyer the right to return the product, the revenue shall be recorded only if all of the conditions have been met. The conditions include all of the following except:
- The seller's price to the buyer is variable and undeterminable at the date of sale
 - The buyer lacks economic substance apart from the seller
 - There is a legal right of offset
 - The amount of future returns can be reasonably estimated
19. With respect to side agreements involving receivables, an auditor should consider the use of additional audit procedures to test for those agreements that may include which one of the following:
- Perform a look back to prior years' agreements
 - Read and understand contracts
 - Send the standard confirmation to the accounts payable department
 - Perform special forensic procedures to uncover the side agreements
20. Which of the following is an element of the predator profile that Bernie Madoff had:
- People around Madoff loved him
 - Madoff had an inferiority complex
 - Madoff apologized too much for his fraud
 - Madoff had the need to look successful
21. Which of the following is an acceptable type of indemnification clause that an auditor can place in his or her engagement letter: Indemnification against _____.
- Auditor's negligence
 - Knowing misrepresentations made by audit client's management
 - Intentional errors committed by the auditor
 - Client unintentional errors
22. Which of the following is a fact identified in a GAO report related to a concentration in the audit market for larger public companies:
- The Big Four audit approximately 50 percent of all U.S. public companies
 - Midsize and smaller firms audit about 40 percent of the smallest public companies
 - Internationally, the Big Four dominate the market for audit services
 - Approximately 90 percent of large companies noted that the number of accounting firms from which they could choose was adequate
23. In the Cornerstone Research report entitled *Accounting Class Action Filings and Settlements-2016 Review and Analysis*, cases involving accountants are:
- Less likely to be dismissed
 - Less complex than cases involving non accountants
 - Are quickly settled
 - Are less costly to defend

24. A top accounting issue cited in lawsuits includes which one of the following:
- a. Overstated liabilities
 - b. Revenue recognition
 - c. Depreciation and amortization
 - d. Understated inventories
25. Which of the following is a recommendation made by the Advisory Committee on the Auditing Profession:
- a. Auditor liability should be limited to a percentage of firm capital
 - b. Large auditing firms should issue audited financial statements to the PCAOB and have audit committees
 - c. The SEC should force the creation of a fifth firm that will compete with the Big Four
 - d. Large auditing firms should all contribute to a defense fund to deal with litigation

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